NOTE

This Microfiche meets the quality requirements of the American National Standard for Microfiche of Documents (ANSI PH5.9-1975). However, because of imperfections in the document from which it was made, it contains images that are illegible or difficult to read. The source document for this microfiche is the best copy that could be obtained prior to filming.

Congressional Information Service, Inc
Washington, D.C

CIS

TAX COMPLIANCE ACT OF 1982 AND RELATED LEGISLATION

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

H.R. 6300

A BILL TO IMPROVE COMPLIANCE WITH THE INTERNAL REVENUE LAWS

MAY 18, 1982

Serial 97-63

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
97-442 O
WASHINGTON : 1982

H 781-39

COMMITTEE ON WAYS AND MEANS

DAN ROSTENKOWSKI, Illinois, *Chairman*

SAM M. GIBBONS, Florida
J. J. PICKLE, Texas
CHARLES B. RANGEL, New York
FORTNEY H. (PETE) STARK, California
JAMES R. JONES, Oklahoma
ANDY JACOBS, Jr., Indiana
HAROLD FORD, Tennessee
KEN HOLLAND, South Carolina
WILLIAM M. BRODHEAD, Michigan
ED JENKINS, Georgia
RICHARD A. GEPHARDT, Missouri
THOMAS J. DOWNEY, New York
CECIL (CEC) HEFTEL, Hawaii
WYCHE FOWLER, Jr., Georgia
FRANK J. GUARINI, New Jersey
JAMES M. SHANNON, Massachusetts
MARTY RUSSO, Illinois
DON J. PEASE, Ohio
KENT HANCE, Texas
ROBERT T. MATSUI, California
DON BAILEY, Pennsylvania
BERYL ANTHONY, Jr., Arkansas

BARBER B. CONABLE, Jr., New York
JOHN J. DUNCAN, Tennessee
BILL ARCHER, Texas
GUY VANDER JAGT, Michigan
PHILIP M. CRANE, Illinois
BILL FRENZEL, Minnesota
JAMES G. MARTIN, North Carolina
L. A. (SKIP) BAFALIS, Florida
RICHARD T. SCHULZE, Pennsylvania
BILL GRADISON, Ohio
JOHN H. ROUSSELOT, California
W. HENSON MOORE, Louisiana

John J. Salmon, *Chief Counsel*
Joseph K. Dowley, *Assistant Chief Counsel*
Robert J. Leonard, *Chief Tax Counsel*
A. L. Singleton, *Minority Chief of Staff*

CONTENTS

Page

Press release of Friday, May 7, 1982, announcing hearing 1

WITNESSES

Department of the Treasury:
  Hon. Roscoe L. Egger, Jr., Commissioner of Internal Revenue 4
  Hon. John E. Chapoton, Assistant Secretary for Tax Policy 34
Department of Justice, Hon. Glenn Archer, Jr., Assistant Attorney General, Tax Division 88
General Accounting Office, William J. Anderson, Director, General Government Division, Daniel C. Harris and John B. Gunner, Group Directors, Tax Administration 107

Alexander, Donald C., former Commissioner of Internal Revenue 168
Alliance of American Insurers, Andre Maisonpierre 300
American Association of Retired Persons, James M. Hacking and Steven Zaleznick 346
American Bankers Association, Lloyd G. Ator, Jr 320
American Bar Association, Section of Taxation, John S. Nolan 192
American Institute of Certified Public Accountants, Federal Tax Division, Subchapter K Task Force, Douglas Banks 262
Ator, Lloyd G., Jr., American Bankers Association 320
Association of Private Pension and Welfare Plans, George W. Cowles and Theodore Rhodes 349
Bankers Trust Co., New York, N.Y., George W. Cowles 349
Banks, Douglas, Subchapter K Task Force, Federal Tax Division, American Institute of Certified Public Accountants 262
Barber, Monty, Direct Selling Association, and Mary Kay Cosmetics 286
Beyer, John, Direct Selling Association, and Robert R. Nathan Associates 286
Citizen's Choice, Inc., Thomas J. Donohue and John Lynch 270
Collins, Adrian, Exxon Corp., and ERISA Industry Committee 351
Cowles, George W., Bankers Trust Co., New York, N.Y., and Association of Private Pension and Welfare Plans 349
Davenport, Prof. Charles, Rutgers University 273
Deloitte, Haskins & Sells, Alexander Zakupowsky, Jr 335
Direct Selling Association, Monty Barber, Neil Offen, John Beyer, and Arthur J. Rothkopf 286
Donohue, Thomas J., Citizen's Choice, Inc 270
Epstein, Norman M., Securities Industry Association 308
ERISA Industry Committee, Adrian Collins and Jerry L. Oppenheimer 351
Exxon Corp., Adrian Collins 351
Ferguson, M. Carr, former Assistant Attorney General, Tax Division, Department of Justice 182
Georgine, Robert, National Coordinating Committee for Multiemployer Plans 345
Hacking, James, National Retired Teachers Association and American Association of Retired Persons 346
Kurtz, Jerome, former Commissioner of Internal Revenue 161
Lynch, John, Citizen's Choice, Inc 270
Maisonpierre, Andre, Alliance of American Insurers 300
Mary Kay Cosmetics, Monty Barber 286
Moorhead, Dwight C., Petro-Lewis Corp 340
Nathan, Robert R., Associates, John Beyer 286
National Association of Manufacturers, Corporate Income Tax and Capital Formation Subcommittee, Charles W. Rau 281
National Coordinating Committee for Multiemployer Plans, Robert Georgine 345
National Retired Teachers Association, James M. Hacking and Steven Zaleznick 346
Nolan, John S., Section of Taxation, American Bar Association 192
Offen, Neil, Direct Selling Association 286
Oppenheimer, Jerry L., ERISA Industry Committee 351
Petro-Lewis Corp., Dwight C. Moorhead 340
Public Securities Association, Municipal Securities Division, Karl H. Velde, Jr 303
Rau, Charles W., Corporate Income Tax and Capital Formation Subcommittee, National Association of Manufacturers 281
Rhodes, Theodore, Association of Private Pension and Welfare Plans 349
Rothkopf, Arthur J., Direct Selling Association 286
Securities Industry Association, Norman M. Epstein 308
Velde, Karl H., Jr., Municipal Securities Division, Public Securities Association 303

Page
Zakupowsky, Alexander, Jr., Deloitte, Haskins & Sells ... 335
Zaleznick, Steven, National Retired Teachers Association and American Association of Retired Persons ... 346

SUBMISSIONS FOR THE RECORD

American Civil Liberties Union, John Shattuck, statement ... 368
American Council of Life Insurance, statement ... 369
American Hotel & Motel Association, statement ... 372
American Pulpwood Association, Kenneth S. Rolston, statement ... 374
American Textile Manufacturers Institute, Inc., W. Ray Shockley, letter ... 377
American Trucking Associations, Inc., Duncan McRae, Jr., statement ... 384
Association of the Bar of the City of New York:
  Richard G. Cohen, letters ... 390
  David R. Tillinghast, letter ... 386
Bernstein, Theodore, International Ladies' Garment Workers' Union National Retirement Fund, statement ... 419
Brooks, Hon. Jack, a Representative in Congress from the State of Texas, chairman, House Committee on Government Operations, letter ... 360
Business Advisory Council on Federal Reports, Eugene J. Hardy letter ... 392
Chamber of Commerce of the United States of America, David E. Franasiak, statement ... 395
Citibank, NA., John F. Rolph III, letter and attachment ... 402
Cohen, Richard G., Association of the Bar of the City of New York, letter ... 390
Ernst & Whinney, Herbert J. Lerner, letter ... 415
Franasiak, David E., Chamber of Commerce of the United States of America, statement ... 395
Hardy, Eugene J., Business Advisory Council on Federal Reports, letter ... 392
Holan, Walter, Profit Sharing Council of America, letter ... 445
Horton, Hon. Frank, a Representative in Congress from the State of New York, statement ... 367
Hotel Employees and Restaurant Employees International Union, Robert E. Juliano, statement ... 418
International Ladies' Garment Workers' Union National Retirement Fund, Theodore Bernstein, statement ... 419
Interstate Natural Gas Association of America, Jerome J. McGrath, letter ... 421
Investment Company Institute, statement ... 423
Juliano, Robert E., Hotel Employees and Restaurant Employees International Union, statement ... 418
Keating, David, National Taxpayers Union, letter ... 443
Kraft, Steven E., Zurich, Switzerland, telegram ... 426
Lerner, Herbert J., Ernst & Whinney, letter ... 415
Machinery & Allied Products Institute, Charles W. Stewart, letter ... 427
Maletta, Thomas P., Tax Executives Institute, Inc., letters and attachments ... 446
Mazawey, Louis T., Western Conference of Teamsters Pension Trust Fund, letter ... 454
McGrath, Jerome J., Interstate Natural Gas Association of America, letter ... 421
McRae, Duncan, Jr., American Trucking Associations, Inc., statement ... 384
National Association of Independent Insurers, statement ... 440
National Restaurant Association, statement ... 442
National Taxpayers Union, David Keating, letter ... 443
New York State Bar Association, Tax Section, Ruth G. Shapiro, letter ... 445
Profit Sharing Council of America, Walter Holan, letter ... 445
Rolph, John F., III, Citibank, NA., letter and attachment ... 402
Rolston, Kenneth S., American Pulpwood Association ... 374
Shapiro, Ruth G., New York State Bar Association, Tax Section, letter ... 445
Shattuck, John, American Civil Liberties Union, statement ... 368
Shockley, W. Ray, American Textile Manufacturers Institute, Inc., letter ... 377
Sparks, Bill J., United Laboratories of America, Inc., letter ... 451
Stewart, Charles W., Machinery and Allied Products Institute, letter ... 427
Storke, Charles A., Western Conference of Teamsters Pension Trust Fund, letter ... 454
Sykes, George K., USAA Investment Management Co., letter ... 451
Tax Executives Institute, Inc., Thomas P. Maletta, letters and attachments ... 446
Tillinghast, David R., Association of the Bar of the City of New York, letter ... 386
United Laboratories of America, Inc., Bill J. Sparks, letter ... 451
USAA Investment Management Co., George K. Sykes, letter ... 451
United States League of Savings Association, statement ... 452
Western Conference of Teamsters Pension Trust Fund, Charles A. Storke and Louis T. Maxawey, joint letter ... 454

THE TAX COMPLIANCE ACT OF 1982, AND RELATED LEGISLATION

TUESDAY, MAY 18, 1982

U. S. House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 10 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[Press release announcing the hearing follows:]

[Press release of Friday, May 7, 1982]

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, Announces a Public Hearing on H.R. 6300, "The Tax Compliance Act of 1982" and Related Legislation

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, today announced the Committee will hold a public hearing on H.R. 6300, "The Tax Compliance Act of 1982," and related legislative proposals. The hearing will be held on Tuesday, May 18, 1982, beginning at 10:00 a.m., in the Committee's main hearing room, 1100 Longworth House Office Building. Chairman Rostenkowski introduced H.R. 6300 on May 6, 1982. The Honorable Barber B. Conable, Jr., introduced H.R. 5829, "The Taxpayer Compliance Improvement Act of 1982," on March 15, 1982, after Senator Robert Dole had introduced an identical bill, S. 2198, in the Senate.

The Committee expects to hear testimony from the Department of the Treasury, the Internal Revenue Service, public and invited witnesses.

BACKGROUND

H.R. 6300 contains six titles which are briefly summarized below along with a brief comparision with H.R. 5829. (For more detailed explanations, see the summary of S. 2198 prepared by the staff of the Joint Committee on Taxation (JCS 6-82) and the explanation of H.R. 6300 included in the Congressional Record for May 6, 1982.)

Title I, Crimes, Abusive Tax Shelters, Fraud, etc.—The bill permits a presumption of jeopardy for purposes of immediately collecting tax on cash connected with illegal activities or where there is no known owner. In addition, U.S., state and local and other bonds offered to the public with maturity dates of one year or more would have to be in registered form after December 31, 1982. Civil penalties are established for the promoters and sellers of abusive tax shelters and for persons who aid or assist knowingly in the understatement of another person's tax liability (including corporations). The fraud penalty is increased by the addition of 50 percent of the interest payable on an underpayment due to fraud and a $500 penalty is established for filing a frivolous return. The administrative summons procedures are revised to place a greater initial burden on taxpayers who wish to challenge a summons. None of the described provisions are included in H.R. 5829; however, H.R. 5829 contains a separate penalty on corporate officers, employees and agents who knowingly participate in a tax fraud affecting the corporation's tax liability.

Title II, Improved Information Reporting.—In addition to increasing the penalties for failure to file required information reports and to supply taxpayer identifying numbers, the bill expands information reporting to include: interest on bearer obligations, in addition to registered bonds; original issue discount on all types of obligations; gross proceeds on certain transaction through brokers and dealers, including barter exchanges; payments made to nonemployees and certain direct sales; state and local tax refunds; and casualty reimbursements. H.R. 5829 contains similar penalty provisions and also extends information reporting to interest on bearer bonds and original issue discount, certain broker transactions and state and local tax refunds. In addition, H.R. 5829 included reports on charged tips. Both bills establish a system of withholding for a repeated failure to provide a taxpayer identify number.

Title III, Pensions and Other Retirement Income.—The bill establishes a system of voluntary withholding on pension annuities and other pension plan distributions. Taxpayers may elect, after notice, not to have withholding apply. Such elections would remain in effect until revoked with respect to annuities. The Secretary of the Treasury is required to establish reporting and record-keeping requirements to improve the information necessary for IRS and taxpayers to determine the proper tax treatment of pension payments. These provisions are similar to those in H.R. 5829. In addition, under H.R. 6300, the penalty for premature withdrawals from an IRA would be increased from 10 percent to 15 percent.

Title IV, Foreign Transactions.—This title contains a number of provisions designed to improve reporting on foreign transactions. In addition, taxpayers would be required to substantiate the nature of foreign transactions having an effect on their U.S. tax liabilities with adequate books, records and other documentation. None of these provisions are included in H.R. 5829.

Title V, Interest Provisions.—The bill changes the rules for computing interest on underpayments and overpayments by requiring daily compounding and by changing the period for which interest will be paid on net operating loss, capital loss and credit carrybacks. In addition, for late filed returns, no interest would be paid on refunds if made within 90 days. H.R. 5829 contains different proposals in these areas. In addition, H.R. 6300 provides an interest surcharge penalty of 20 percent of the interest payable for substantial underpayments. H.R. 5829 contains a "no fault" penalty of 10 percent of any underpayment arising from an undisclosed item. H.R. 5829 would also require a semi-annual determination of interest rates for tax purposes and would impose a minimum penalty for late filing of a return.

Title VI, Partnership and Subchapter S.—This title provides for consolidated administrative and judicial proceedings for determining the nature of partnership or Subchapter S items at the partnership or corporate level, respectively. These provisions are not included in H.R. 5829.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentation will be limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for Committee members to interrogate witnesses. The witnesses will be grouped as panels to expedite the hearing, and strict time limitations will be established for each panelist.

The following is an outline of the procedure to be followed by organizations and individuals who either may want to appear and testify during this hearing or file a written statement for the printed record of the proceedings. All requests should contain the following information:

1. The name of the witness, his title, address, firm affiliation and/or organization he will represent (as well as a telephone number where he or his designated representative may be reached).
2. If appearing in an individual capacity, a list of any clients at whose request or in whose employ the witness appears.
3. A topical outline or summary of comments and recommendations.

Requests to be heard must be made by telephone to Ms. Harriett Lawler [telephone (202) 225-3627] by the close of business, Thursday, May 13, 1982. The telephone request should be followed by a formal written request addressed to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

Witnesses are required to submit 125 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to comply with this rule may result in the witness not being allowed to testify.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies are required and must be received by the close of business, Friday, May 21, 1982. These statements should contain the information listed in #1-3 earlier in this press release. The statements should be delivered to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office during the course of the hearing.

Chairman ROSTENKOWSKI. The committee will come to order.

Today's hearing has been called to receive testimony on two omnibus bills designed to improve compliance with our tax laws. On May 6, 1982, I introduced H.R. 6300, the Tax Compliance Act of 1982, which was developed after many weeks of cooperative effort on the part of the majority and minority staffs of the Committee on Ways and Means, the staff of the Joint Committee on Taxation, the staff of the Treasury Department, and the Internal Revenue Service, and, of course, the legislative counsel's office.

The starting point for this effort was S. 2198 and H.R. 5829, the Taxpayer Compliance Improvement Act of 1982, introduced by Senator Bob Dole and the Honorable Barber Conable, respectively, in March of this year. Obviously, there are provisions in each of these bills that are controversial, and some that impose new burdens on taxpayers and various institutions. We might individually prefer a different approach to solve the problems addressed by these bills. In a more perfect world, such legislation would not be necessary because of near-perfect tax compliance evolving from a simpler and more administrable tax system. or a comprehensive system of income tax withholding.

Unfortunately, the real world bears little resemblance to this vision. We have an extraordinarily complex tax system that invites abuse, evasion, and other types of noncompliance. Preliminary findings from the IRS's new study of the tax gap due to various types of tax noncompliance indicate that the tax gap from unreported income by individuals has more than doubled in the 5 years since 1976, amounting to $66 billion in 1981. The illegal-sector tax gap has also doubled and may account for as much as $10 billion in lost tax revenues. Overstated expenses, deductions, and credits on individual and business returns now account for $12 billion of the tax gap.

These numbers are staggering. It is painfully obvious that our current budget problems would be largely solved if everyone were paying their tax as required under the law. In the interest of fairness to the larger number of taxpayers who do comply with the law, we must begin to address this growing problem.

The solutions available are not easy ones. While expanding the withholding system to other sources of income would be more effective and efficient, there is little support for that approach. Accordingly, these bills rely primarily upon an expanded and more effective system of information reporting. In addition, withholding on pension payments is encouraged, and new penalties are established to discourage abusive tax shelters and tax-protest schemes.

H.R. 6300 also contains provisions designed to better address the problems encountered in illegal activities and foreign transactions.

Finally, provisions are included to establish more effective procedures for auditing large partnerships and subchapter S corporations.

In conclusion, let me say that I am fully aware that these bills represent only a partial solution to a very large and perhaps systemic problem. Many believe that noncompliance has increased because of an increasing disrepect for a complex and inequitable tax system. Under that view, we are talking about Band-Aids here and not surgery. For the near term, the approach taken in these bills is the feasible one. but I agree that we in the Congress must not lose sight of the more basic issue.

While these bills may represent imperfect solutions, the effort is nonetheless necessary to restore some semblance of fair play and to begin to address growing noncompliance more effectively. I would urge the witnesses to keep this thought in mind, and to be as constructive as possible in their testimony, realizing the magnitude of the problems we collectively face, both in terms of tax compliance and the current budget outlook.

Finally, I would point out to our witnesses from the administration that the ultimate success of the proposals included in these bills for improving compliance will largely depend on adequate resources being consistently provided to the Internal Revenue Service in all functional areas. Shortsighted budget policies can undo much of what we are striving to accomplish in this bill.

With that, let us begin with our first panel of administration witnesses, IRS Commissioner Egger, and Mr. Glenn Archer, Jr., Assistant Attorney General, Tax Division, of the Justice Department. I am sure that Mr. Chapoton, who is going to present the views of the Treasury Department, will be here in a short while.

Mr. Commissioner, if you will proceed with your testimony, the committee is ready to receive it.

STATEMENT OF HON. ROSCOE L. EGGER, JR., COMMISSIONER OF INTERNAL REVENUE, DEPARTMENT OF THE TREASURY

Mr. EGGER. Thank you, Mr. Chairman.

I really appreciate the opportunity to be here today and to discuss this compliance tax gap problem. I am truly pleased that you have chosen to grapple with this tough issue, and I am particularly gratified by the interest that you and Mr. Conable have shown in finding legislative solutions to the problem. Given the state of the economy, it is imperative that we focus on methods to collect the tax from those who are not paying their fair share without imposing new tax burdens on those who already voluntarily comply with our tax laws.

Rather than reading my rather lengthy prepared statement on the tax gap and the components, I would like to briefly note some of the highlights of the important areas as we see them. I would ask that my full prepared statement be included in the record.

Chairman ROSTENKOWSKI. Mr. Commissioner, if you would like to summarize your statement will be placed in the record in its entirety.

Mr. EGGER. Thank you.

Of primary importance is the need to keep the tax gap in perspective during our discussions. While we would all agree that it is a serious problem, hence the meeting here today, we should also note that the tax administration system is not collapsing. It is a sound, viable system that is by any measure one of the most effective and one of the most efficient anywhere in the world. The success of our tax system rests heavily on the voluntary self-assessment and compliance by the taxpayers in this country. Beyond any doubt, most taxpayers are conscientious and honest. This is borne out by the fact that approximately 80 percent of taxes owed are reported and paid voluntarily without any IRS enforcement effort at all. This voluntary compliance in turn is based on taxpayers' perceptions that the tax system is operated in a fair, equitable, but firm manner. We applaud your efforts through this bill to reinforce these perceptions, and to make sure they continue to be a reality.

Our latest estimate is that the total legal sector gap has tripled in 8 years from about $29 billion in 1973 to nearly $87 billion in 1981. Our projections are that this legal sector tax gap will continue to increase if no significant inroads are achieved, and we will reach nearly $120 billion in 1985. At the same time, the gap in the illegal sector is estimated to have increased from about $2.5 billion in 1973 to roughly $8 billion in 1981, with a projected increase to about $13 billion in 1985.

In addition to these tax gap estimates, we have approximately $20.5 billion from cases in our 1981 accounts receivable inventory. Recently, the number of accounts receivable and the amounts involved have begun to increase more rapidly than our ability to collect them, largely because of inadequate resources. I am pleased to report that the revenue initiative which is included in our fiscal 1983 budget should permit us to reduce this inventory somewhat.

The Service is already taking a number of steps to better combat the tax gap. The Service's fiscal year 1983 budget, on which I testified before the House and Senate Appropriations Subcommittees last month, contains some significant increases to improve IRS effectiveness and efficiency of operation, as well as to increase tax enforcement.

In addition to the efforts aimed at reducing the inventory of assessed but uncollected taxes, we have requested additional personnel in order to increase audit coverage and to decrease the cases in appeals inventory. The proposed budget will also accelerate our automation efforts in order to substantially reduce the time consuming manual processing involved in the auditing of taxpayers and the collection of taxes due.

Legislation such as that which you and Mr. Conable have proposed is needed, however, if we are going to make significant inroads into the tax gap. It simply is neither cost effective nor practical to expect that individual audits will enable the Service to significantly reduce the levels of unreported income. This can best be done only through providing the Service with information on the transactions giving rise to the income or by withholding on the payment of the income.

Both bills would significantly expand the amount of information reported to the Service, and in the pension area should increase the number of persons electing to have withholding applied to their pension and annuity payments. Both H.R. 6300 and H.R. 5829 contain provisions to aid the Service in dealing with those taxpayers who claim excessive deductions.

The bills accomplish this by first increasing the risk involved in such activity through their increased penalty provisions. Second, H.R. 6300 would allow the Service to enjoin fraudulent tax-avoidance schemes on the front end, so to speak, that is, before they are sold to taxpayers. Third, and perhaps most important, the partnership audit provision would enable the Service to significantly reduce the staff time needed to audit abusive tax shelter schemes.

We are aware that a concern in the private sector is that some of the provisions of these bills could create an additional paperwork burden. I would like to emphasize my personal commitment as well as that of the agency to work with all affected industries and their representatives to keep any burdens to an absolute minimum, consistent, of course, with our need to obtain appropriate information. I also want to point out that providing individual taxpayers with the same information at the time they file their returns should significantly reduce the paperwork burden that they face in maintaining the records necessary to complete their returns.

On this same subject, let me assure you, Mr. Chairman, that the Service can and will use whatever information we receive from industry. We have underway now a series of initiatives including the upgrading of our computer system which will better enable us to use all of the information that we will ultimately receive.

Mr. Chairman, I appreciate your concerns about this important area of tax administration, and endorse your proposals and those of Mr. Conable to combat the problems it presents. The Service will be pleased to work further with this committee and with its staff in order to continue to refine the approaches to specific areas of concern. As I understand it, Mr. Chapoton will be a bit delayed, and so perhaps the Assistant Attorney General can proceed with his testimony, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF ROSCOE L. EGGER, JR.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE YOU TODAY TO DISCUSS THE COMPLIANCE "TAX GAP." I AM PLEASED THAT YOU HAVE CHOSEN TO GRAPPLE WITH THIS TOUGH ISSUE, AND I AM PARTICULARLY GRATIFIED BY THE INTEREST YOU AND MR. CONABLE HAVE SHOWN IN FINDING LEGISLATIVE SOLUTIONS TO THIS PROBLEM THE SERVICE BELIEVES THAT LEGISLATIVE SOLUTIONS ARE APPROPRIATE IN A NUMBER OF TAX GAP AREAS, AND WE ARE ESPECIALLY PLEASED THAT YOUR BILL HAS ADDRESSED THE KEY AREAS OF ABUSIVE TAX SHELTERS, TRANSACTIONS OUTSIDE THE UNITED STATES, ITEMS USED IN ILLEGAL ACTIVITIES, AND INFORMATION REPORTING GENERALLY. COLLECTIVELY, YOUR PROPOSALS WILL PROVIDE THE SERVICE WITH MUCH-NEEDED TOOLS TO ATTACK THE TAX GAP. ASSISTANT SECRETARY CHAPOTON WILL DISCUSS THE SPECIFICS OF THE BILL SHORTLY.

IN MY TESTIMONY, I WILL ATTEMPT TO BRIEFLY REVIEW THE VARIOUS COMPONENTS OF THE TAX GAP, POINT OUT THE SERVICE'S EFFORTS TO DEAL WITH THESE AREAS, AND INDICATE WHAT ADDITIONAL LEGISLATIVE MEASURES WOULD BE HELPFUL TO US. TO ASSIST ME, I HAVE JIM OWENS, THE DEPUTY COMMISSIONER, HERE TODAY.

DEFINITION OF THE TAX GAP AND RELATED ITEMS

THE TERM "TAX GAP" AS I WILL USE IT HERE TODAY IS MEANT TO APPLY TO ALL REVENUE LOST TO THE U.S. TREASURY THROUGH NONCOMPLIANCE WITH OUR TAX LAWS. AS SUCH, IT INCLUDES LOSSES FROM UNREPORTED INCOME AND UNDERREPORTED INCOME, AS WELL AS OVERSTATED EXPENSES, DEDUCTIONS, AND EXEMPTIONS CLAIMED ON FILED RETURNS. IT COVERS REVENUES LOST FROM NONCOMPLIANCE BY CORPORATIONS AND BY INDIVIDUALS IN BOTH THE LEGAL SECTOR AND THE ILLEGAL SECTOR OF THE ECONOMY.

THE SERVICE HAS BEEN DEEPLY CONCERNED WITH THIS ISSUE FOR SOME YEARS, AND ISSUED A FORMAL REPORT ON IT, ESTIMATES OF INCOME UNREPORTED ON INDIVIDUAL INCOME TAX RETURNS, IN SEPTEMBER 1979. THAT REPORT INTRODUCED TWO TERMS MENTIONED ABOVE WHICH I WOULD LIKE TO DEFINE NOW FOR OUR COLLECTIVE EASE OF REFERENCE. "LEGAL SECTOR" EARNINGS INCLUDE INCOMES FROM REGULARLY ESTABLISHED ENTERPRISES OR OCCUPATIONS, AND FROM LEGAL ACTIVITIES THAT ARE SOMETIMES CALLED IRREGULAR BECAUSE THEY TAKE PLACE IN INFORMAL SETTINGS. EXAMPLES OF THESE "LEGAL SECTOR" EARNINGS WHICH ARE SOMETIMES UNREPORTED INCLUDE INTEREST AND DIVIDENDS, TIPS, AND EARNINGS OF INDEPENDENT CONTRACTORS. BY COMPARISON, "ILLEGAL SECTOR" INCOMES ARE THOSE DERIVED FROM ORGANIZING, FINANCING, PRODUCING, AND DELIVERING ILLEGAL GOODS OR SERVICES RELATED TO DRUGS, GAMBLING, PROSTITUTION, AND SO ON. ESTIMATES IN THIS SECTOR ARE PARTICULARLY DIFFICULT TO OBTAIN, NEEDLESS TO SAY.

THE SERVICE IS WORKING NOW TO UPDATE THE DATA IN THE 1979 REPORT, AND EXPECTS TO HAVE THE NEW REPORT AVAILABLE THIS SUMMER. ONE DEFINITIONAL CHANGE WE WILL BE MAKING IN THE NEW REPORT WILL BE TO DISTINGUISH IN OUR ESTIMATES BETWEEN AMOUNTS RELATED TO UNDERREPORTING OR NON-REPORTING, AND AMOUNTS RELATED TO THE OVERSTATEMENT OF EXPENSES OR DEDUCTIONS. WE BELIEVE THIS DIFFERENTIATION IS ESSENTIAL IN GUIDING THE SERVICE'S ENFORCMENT EFFORTS TO THE AREAS OF GREATEST OPPORTUNITY. ADDITIONAL CHANGES INCLUDE A NEW ANALYSIS OF THE CORPORATE SECTOR TAX GAP, COVERAGE OF MORE TAX YEARS (1973-1981), AND MORE SOPHISTICATED METHODOLOGY GENERALLY. I HAVE INCLUDED A MORE DETAILED DESCRIPTION OF THESE DIFFERENCES AS AN APPENDIX TO THIS STATEMENT.

I AM PREPARED TO DISCUSS SOME OF OUR PRELIMINARY FINDINGS AND DATA FROM THE NEW REPORT TODAY, ALTHOUGH I MUST CAUTION YOU THAT THE FIGURES I HAVE NOW MAY BE REVISED IN OUR FINAL REPORT. THE BULK OF THE DATA NOW AVAILABLE RELATES TO INDIVIDUALS. DETAILED INFORMATION ON CORPORATIONS AND THE ILLEGAL SECTOR WILL NOT BE AVAILABLE UNTIL LATER THIS YEAR. I ALSO HAVE INFORMATION ON THE SIZE AND SCOPE OF THE ACCOUNTS RECEIVABLE PROBLEM FACING US, WHICH WE PERCEIVE AS AN IMPORTANT PART OF OUR OVERALL COMPLIANCE EFFORT, IF NOT AN INTEGRAL PART OF THE TAX GAP PER SE.

Overview of Tax Gap

The tax gap has been a problem for years, but recently the dollars involved have reached levels which we believe are unacceptable. Our latest estimate is that the total legal sector gap has tripled in eight years, from $29 billion in 1973 to $87 billion in 1981. Our projections are that this legal sector tax gap will continue to increase, if no significant inroads are made on the problem, and will reach nearly $120 billion in 1985. At the same time, our estimates would indicate that the gap in the illegal sector has increased from about $2 1/2 billion in 1973 to $8 billion in 1981, with a projected increase to $13 billion in 1985.

In addition to these tax gap estimates, we have approximately $20.5 billion dollars from cases in our 1981 accounts receivable inventory. These are amounts owed by taxpayers much of which in the past we have not been able to collect, largely because of inadequate resources. I am pleased to report that the revenue initiative in our 1983 budget should allow us to reduce this inventory.

Despite the magnitude of the problem, I can't emphasize too strongly that most taxpayers are conscientious, and that the tax system is basically sound and reliable. The tax reported voluntarily - that is, without any enforcement effort - is approximately 80 percent of what is owed. We should not overlook, however, the fact that this voluntary

COMPLIANCE RESULTS LARGELY FROM A VERY WORKABLE SYSTEM OF TAX ADMINISTRATION RULES BASED ON WITHHOLDING AND INFORMATION REPORTING, AND A TRADITION OF EFFECTIVE AND FAIR TAX ADMINISTRATION.

THE SERVICE IS COMMITTED TO STUDYING THE PROBLEM OF NONCOMPLIANCE ON A CONTINUING BASIS TO IMPROVE WHAT IS, BY ANY MEASURE, ONE OF THE FINEST TAX SYSTEMS IN THE WORLD. I BELIEVE BOTH OF THESE BILLS TAKE A MAJOR, POSITIVE STEP IN THIS DIRECTION. I AM CONVINCED THAT ONLY AS WE FOCUS ON THOSE AREAS WHERE TAXPAYERS ARE NOT REPORTING THEIR FULL TAX LIABILITY CAN WE ASSURE THE GREAT MAJORITY OF TAXPAYERS IN OUR COUNTRY THAT EVERYONE WILL BE REQUIRED TO PAY THEIR FAIR SHARE.

COMPONENTS OF THE TAX GAP

NOW, MR. CHAIRMAN, I WOULD LIKE TO BRIEFLY REVIEW THE VARIOUS COMPONENTS OF THE TAX GAP AS WE SEE THEM. I WILL ALSO ATTEMPT TO INDICATE, FOR EACH COMPONENT, OUR AREA(S) OF GREATEST CONCERN AND THE ADDITIONAL MEASURES WHICH WOULD ASSIST US IN THESE PROBLEM AREAS.

PERHAPS IT WOULD HELP CONCEPTUALLY TO VIEW THE TAX GAP AS A SORT OF REAL-LIFE RUBIK'S CUBE. THAT IS, THE TAX GAP IS MULTI-DIMENSIONAL, AND IS COMPOSED OF A NUMBER OF INTERRELATED

PARTS. EFFORTS AIMED AT ONE ASPECT OF THE TAX GAP MAY NOT BE SUITABLE, OR EVEN RELEVANT, TO OTHER ASPECTS. MOST IMPORTANTLY, HOWEVER, THE PROBLEM MUST BE VISUALIZED IN ITS ENTIRETY FOR MAXIMUM COMPREHENSION.

BECAUSE THE LARGEST PORTION OF THE TAX GAP IS FROM LEGAL SOURCE INCOME THAT IS NOT REPORTED BY INDIVIDUALS, I WILL CONCENTRATE IN THE DISCUSSION OF EACH COMPONENT OF THE TAX GAP ARISING FROM UNREPORTED INCOME BY INDIVIDUAL TAXPAYERS. IN DISCUSSING EACH COMPONENT, I WILL TRY TO GIVE YOU AN IDEA OF THE ESTIMATED REVENUE LOST FROM THE UNDERREPORTING. OUR FINAL REPORT WILL CONTAIN MORE INFORMATION ON THE REVENUE LOST AS A RESULT OF OVERSTATED DEDUCTIONS AND CREDITS BY INDIVIDUALS AND MORE INFORMATION ON THE CORPORATE AND ILLEGAL SECTORS. UNLESS OTHERWISE NOTED, THESE FIGURES DEAL ONLY WITH RETURNS FILED, BECAUSE WE ARE STILL DEVELOPING INFORMATION ON THE INCOME SOURCES OF NONFILERS.

1. FARM AND NON-FARM BUSINESSES

THE LARGEST SINGLE CATEGORY OF UNREPORTED INCOME IS FROM INDIVIDUAL NONFARM BUSINESS ACTIVITIES, WHICH IN 1981 ACCOUNTED FOR $26 BILLION OR 31 PERCENT OF THE TOTAL TAX GAP. THIS CATEGORY INCLUDES UNREPORTED INCOME FROM A LARGE NUMBER OF SMALL TRANSACTIONS AT THE RETAIL LEVEL, NONREPORTING OF PAYMENTS RECEIVED BY INDEPENDENT CONTRACTORS, AND RECEIPTS FROM DIRECT OR

DOOR TO DOOR SALES. ABOUT 20 PERCENT OF IT COMES FROM SELF-EMPLOYED MOONLIGHTERS AND "INFORMAL SUPPLIERS" WHO PROVIDE GOODS AND SERVICES. THE OTHER 80 PERCENT COMES FROM WHAT WE CALL THE FORMAL SECTOR, WHICH INCLUDES FULL TIME SOLE PROPRIETORSHIPS - FOR EXAMPLE, ARCHITECTS, ENGINEERS, PHYSICIANS, LAWYERS, RETAIL STORE OPERATORS, BUILDING CONTRACTORS, SALESMEN, ETC.

VERY LITTLE OF THIS INCOME IS REQUIRED TO BE REPORTED UNDER CURRENT INFORMATION REPORTING REQUIREMENTS. EVEN WHERE REPORTING IS REQUIRED, COMPLIANCE BY PAYERS IS POOR, AND SOME OF THESE WHO DO REPORT PROVIDE INADEQUATE OR INACCURATE INFORMATION. WHEN THE INACCURATE INFORMATION IS THE TAXPAYER IDENTIFICATION NUMBER OF THE PAYEE, IT MAKES IT VERY COSTLY AND DIFFICULT FOR THE SERVICE TO USE THE INFORMATION.

A RECENT STUDY OF SMALL AND MEDIUM SIZED CORPORATE PAYERS REVEALED THAT ABOUT 50 PERCENT OF THESE CORPORATIONS FAILED TO FILE ANY OF THE FORMS 1099 MISC'S REQUIRED, AND ANOTHER 11 PERCENT DID NOT FILE ALL THE DOCUMENTS. MORE IMPORTANTLY, WHEN WE FOLLOWED UP TO SEE IF THE RECIPIENT OF THE INCOME HAD REPORTED THE PAYMENTS, WE FOUND THAT COMPLIANCE BY PAYEES WHO DID NOT RECEIVE INFORMATION STATEMENTS WAS CONSIDERABLY LOWER THAN BY THOSE WHO DID.

THE EMPLOYEE-INDEPENDENT CONTRACTOR AREA IS PARTICULARLY IN NEED OF CONGRESSIONAL ATTENTION. SINCE 1979, CONGRESS HAS PROHIBITED THE IRS FROM ISSUING REGULATIONS AND RULINGS IN THIS AREA. OUR ABILITY TO MAKE A SIGNIFICANT DENT IN THE TAX GAP FROM INDEPENDENT CONTRACTORS AND DIRECT SELLERS IS LARGELY DEPENDENT ON CONGRESSIONAL ACTION.

THE INCREASE IN THE PENALTIES FOR FAILURE TO COMPLY WITH PRESENT REPORTING REQUIREMENTS SHOULD BE OF SUBSTANTIAL HELP TO THE SERVICE IN REDUCING THE TAX GAP FOR THIS AREA. WE ARE ALSO PLEASED THAT H.R. 6300 IMPOSES ADDED INFORMATION REPORTING REQUIREMENTS ON THE DIRECT SALES INDUSTRY. WHILE WE BELIEVE THAT OTHER INFORMATION WOULD BE MORE USEFULL TO THE SERVICE, IT IS IMPORTANT THAT SOME FORM OF REPORTING REQUIREMENTS BE IMPOSED.

2. CAPITAL GAINS

THE SECOND LARGEST UNREPORTED INCOME AREA IS CAPITAL GAINS, WHICH ACCOUNTED FOR $9.1 BILLION OF THE TAX GAP FOR 1981 OR 11 PERCENT OF THE TOTAL TAX GAP FROM INDIVIDUALS, COMPARED TO $2 BILLION OR 7 1/2 PERCENT IN 1973. THIS GROWTH IS RELATED CLOSELY TO THE EFFECT OF INFLATION ON ASSET VALUES AND ON TAXPAYER BEHAVIOR.

AT THE PRESENT TIME, THERE IS NO INFORMATION REPORTING REQUIREMENT ON MOST OF THE TRANSACTIONS GIVING RISE TO CAPITAL GAINS. CERTAIN PORTIONS OF UNDERREPORTING IN THIS AREA COULD EASILY BE ADDRESSED BY INFORMATION REPORTING. THIS IS PARTICULARLY TRUE FOR UNDERREPORTING OF THE GAINS DIRECTLY ATTRIBUTABLE TO THE SALE OF SECURITIES AND COMMODITIES. WE BELIEVE THAT REPORTS OF GROSS SALE PROCEEDS WILL PROVIDE US WITH THE INFORMATION WE NEED TO ADDRESS THE UNDERREPORTING AND, AT THE SAME TIME, NOT BE TOO BURDENSOME AND COSTLY TO THE INDUSTRY.

OTHER PORTIONS OF THIS COMPONENT MAY BE MORE DIFFICULT TO GET AT LEGISLATIVELY, SUCH AS THE SUBSTANTIAL UNDERREPORTING OF GAINS ON THE SALE OF PERSONAL RESIDENCES AND ON OTHER REAL ESTATE; GAINS ON THE SALE OF COLLECTIBLES, SUCH AS GOLD AND SILVER, GEMS, AND ART OBJECTS; GAINS ON TIMBER AND LIVESTOCK; AND SALE OF PROPERTY USED IN A TRADE OR BUSINESS. ONE ADMINISTRATIVE TECHNIQUE WE ARE BEGINNING TO PERFECT FOR SELECTED ITEMS IN THIS CATEGORY IS OUR DEFERRED ADVERSE TAX CONSEQUENCES PROGRAM. USING THIS PROGRAM, WE CAN TRACK THE DEFERRAL OF TAX CONSEQUENCES FROM ONE RETURN YEAR TO ANOTHER. FOR EXAMPLE, DEFERRED GAINS ON THE SALE OF RESIDENCES COULD BE TRACKED TO INSURE THAT THE COST OR OTHER BASIS OF REPLACEMENT RESIDENCES ARE REDUCED ACCORDINGLY. WE ARE

ALSO UNDERTAKING A RESEARCH PROJECT WHICH WOULD TEST THE FEASIBILITY OF USING PRIVATE SECTOR DATA ON REAL ESTATE TRANSACTIONS TO ENSURE CORRECT REPORTING OF SUCH SALES ON TAX RETURNS.

3. Dividends and Interest

The tax gap for unreported and underreported dividends and interest is estimated at $8.2 billion in 1981 for filers and nonfilers together ($7.7 billion for filers only). Of the 7.7 billion total, some $3.6 billion is from dividends, and about $4.1 billion is interest. This is an increase of 356 percent from the estimated gap from both groups of $1.8 billion in 1973.

Approximately 37 percent of the dividend and interest tax gap is due to the failure of individuals to report dividend and interest payments that are covered under current information reporting requirements.

In addition, something like 26 percent of the tax gap in this component could well be a direct result of current law, which exempts major payers, including the U.S. Government, from reporting interest on bearer securities and other debt obligations.

THE REGISTRATION REQUIREMENTS AND INCREASED REPORTING REQUIRED UNDER BOTH BILLS WILL CERTAINLY HELP TO REDUCE THE GAP IN THIS AREA.

4. PARTNERSHIP AND ELECTING SMALL BUSINESS CORPORATIONS

TAKEN TOGETHER, THESE INCOME SOURCES REPRESENT THE NEXT MOST IMPORTANT SOURCE OF THE UNREPORTED INCOME TAX GAP AT $7.2 BILLION, OR ABOUT 9 PERCENT OF THE TOTAL TAX GAP FROM INDIVIDUAL INCOME TAX RETURNS FOR 1981. THIS IS A SUBSTANTIAL INCREASE FROM THE $1.9 BILLION OF 1973; MOST OF THE INCREASE COMES FROM PARTNERSHIPS.

WHILE UNDERREPORTING OF INCOME BY THESE ENTITIES IS CLEARLY A SUBSTANTIAL PROBLEM, PERHAPS EQUALLY IMPORTANT IS THE OVERSTATEMENT OF EXPENSES AND DEDUCTIONS. ONE OF THE REASONS FOR THE GROWTH OF THIS PORTION OF THE PROBLEM IS THE INCREASE IN THE NUMBER OF PERSONS WILLING TO PLAY THE "AUDIT LOTTERY." THIS CAN BE DEFINED AS A GAME PLAYED BY A GROWING NUMBER OF TAXPAYERS AND PRACTITIONERS IN WHICH THEY REPORT ITEMS ON THEIR RETURN IN A MANNER CLEARLY INCONSISTENT WITH ESTABLISHED SERVICE POSITION OR JUDICIAL INTERPRETATION OF THE LAW OR REGULATIONS AS APPLIED TO THE TAXPAYER'S CIRCUMSTANCES. THESE PRACTICES ARE COUPLED WITH THE REPORTING OF SUFFICIENT INFORMATION TO PRECLUDE THE IMPOSITION OF THE FRAUD OR NEGLIGENCE PENALTY, BUT NOT SUFFICIENT

ENOUGH TO CLEARLY INDICATE THE NATURE OF THE ITEM. TAXPAYERS DO THIS FOR TWO BASIC REASONS: FIRST, THE PROBABILITY OF THEIR RETURN BEING SELECTED FOR AUDIT IS VERY SMALL. SECOND, AND PROBABLY MORE IMPORTANT, THE TAXPAYER'S RISK IS GENERALLY LIMITED TO THE INTEREST ON ANY DEFICIENCY THAT MIGHT BE DETERMINED.

WHILE THE ECONOMIC RECOVERY TAX ACT PROVISION FOR AN ADDITION TO TAX IN CASES OF VALUATION OVERSTATEMENT SHOULD HELP DISCOURAGE THE AUDIT LOTTERY, MUCH MORE NEEDS TO BE DONE. WE NEED TO FURTHER INCREASE THE RISK TO PERSONS WHO ARE INCLINED TO PLAY THE GAME.

BOTH H.R. 6300 AND H.R. 5829 WOULD ADD SUBSTANTIALLY GREATER PENALTIES FOR TAXPAYERS TO CONSIDER AS THEY CONTEMPLATE THEIR CHANCES IN THE AUDIT LOTTERY. IN ADDITION, H.R. 6300 WOULD GIVE THE SERVICE THE ABILITY TO GO AFTER THE PROMOTER OF AN ABUSIVE TAX SCHEME AS SOON AS IT IS MARKETED RATHER THAN BEING FORCED TO WAIT UNTIL TAXPAYERS FILE THEIR RETURNS. WE BELIEVE THIS IS AN IMPORTANT AND NECESSARY TOOL FOR THE SERVICE TO HAVE IF THESE SCHEMES ARE TO BE STOPPED.

PERHAPS THE BIGGEST ADMINISTRATIVE PROBLEM THE IRS ENCOUNTERS IN AUDITING RETURNS OF PARTNERS IS THE REQUIREMENT TO DEAL SEPARATELY WITH THE RETURN FOR EACH MEMBER IN A PARTNERSHIP. THIS ENCOURAGES PROMOTERS OF

ABUSIVE TAX SHELTERS TO STRUCTURE THEIR SCHEMES AS PARTNERSHIPS THAT ARE MULTI-TIERED, WITH WIDE GEOGRAPHIC DISPERSION OF PARTNERS. BECAUSE OF THIS, WE OFTEN ARGUE THE SAME ISSUES MANY TIMES OVER. WE BELIEVE THAT PARTNERSHIPS SHOULD HAVE A SEPARATE STATUTE OF LIMITATIONS FOR PARTNERSHIP ITEMS; SINGLE AUDIT AND ADMINISTRATIVE APPEALS PROCEEDINGS SHOULD TAKE PLACE IN THE IRS DISTRICT WHERE THE PARTNERSHIP IS LOCATED; AND THE PARTNERSHIP SHOULD HAVE A SINGLE JUDICIAL PROCEEDING TO CONTEST AN IRS PARTNERSHIP ADJUSTMENT. THESE PRINCIPLES ARE INCLUDED IN THE PARTNERSHIP AUDIT PROPOSALS CONTAINED IN H.R. 6300.

5. PENSIONS

THE TAX GAP FROM PENSIONS IS ESTIMATED TO BE $2.8 BILLION IN 1981, WHICH IS A FOUR-FOLD INCREASE FROM THE $700 MILLION OF 1973. UNDERREPORTING IN THIS AREA CAN BE EXPECTED TO GROW EVEN MORE IN THE FUTURE. THIS RESULTS FROM SEVERAL FACTORS. ONE IS A GENERAL RISE IN THE PERCENT OF THE U.S. POPULATION PAST RETIREMENT AGE; A SECOND IS THE EXPANSION OF PENSION OR RETIREMENT PLANS. A THIRD FACTOR IS THE COMPLEXITY FACED BY A RETIREE IN ATTEMPTING TO DETERMINE SUCH THINGS AS HOW MUCH OF THE PENSION TO REPORT AND, FOR MANY, HOW TO COMPLY WITH THE ESTIMATED TAX PAYMENT RULES. IT IS IMPORTANT TO NOTE HERE THAT WHEN WE REFER TO PENSIONS, WE ARE NOT SPEAKING OF THE SOCIAL SECURITY SYSTEM. WE

ARE ONLY SPEAKING OF PENSIONS ARISING FROM EMPLOYER OR UNION PENSION PLANS, IRAs, ANNUITY PLANS, DEFERRED COMPENSATION PLANS, ETC.

GIVEN THESE COMPLEXITIES, THE SIMPLEST WAY TO ENSURE FULL REPORTING IN THIS AREA IS THROUGH A WITHHOLDING SYSTEM. SINCE SUCH A SYSTEM WOULD BE VERY SIMILAR TO THE PRESENT GRADUATED WITHHOLDING SYSTEM, IT SHOULD BE EASY TO DEVELOP. IN MUCH THE SAME WAY THAT INITIAL INSTITUTION OF THE WITHHOLDING SYSTEM WAS VIEWED AS A SERVICE TO WAGE EARNERS, WE BELIEVE INSTITUTION OF A SIMILAR SYSTEM FOR PENSIONERS CAN BE VIEWED AS A BENEFIT, ENABLING THEM TO CONTINUE MEETING THEIR TAX OBLIGATIONS ON A PAY-AS-YOU-GO BASIS, WITH A MINIMUM IMPACT ON THE INDIVIDUALS. THE WITHHOLDING AND INFORMATION REPORTING RULES CONTAINED IN THESE BILLS ARE AN IMPORTANT FIRST STEP IN SOLVING THESE PROBLEMS.

6. WAGES AND SALARIES (INCLUDING TIPS)

WHILE THE DOLLAR AMOUNT OF THE TAX GAP FROM UNREPORTED WAGES, SALARIES, AND OTHER EMPLOYEE COMPENSATION, APPROXIMATELY $4.8 BILLION IN 1981, IS LARGE, THE REVENUE LOSS REPRESENTS ONLY ONE PERCENT OF THE TOTAL EMPLOYEE COMPENSATION PAID. THIS EXTREMELY HIGH COMPLIANCE RATE IS, I BELIEVE, DIRECTLY ATTRIBUTABLE TO WITHHOLDING.

MOST OF THE NONCOMPLIANCE IN THIS COMPONENT IS FROM CASH PAYMENTS MADE TO SO-CALLED "CASUAL" EMPLOYEES OR MOONLIGHTERS, AND HOUSEHOLD AND AGRICULTURAL WORKERS. IN THESE CIRCUMSTANCES, NEITHER REPORTING NOR WITHHOLDING IS GENERALLY REQUIRED; AND WHEN IT IS, IT OFTEN DOES NOT OCCUR. THERE IS NO "PAPER TRAIL" TO FOLLOW IN OUR ENFORCEMENT ACTIVITIES, AND WE HAVE AN EXTREMELY DIFFICULT TIME IN TRYING TO UNCOVER NONCOMPLIANCE.

THE SECOND MAJOR SOURCE OF NONCOMPLIANCE WITH WAGE REPORTING IS FROM TIPS. WE ESTIMATE THAT THE TAX GAP FROM TIPS ALONE WAS APPROXIMATELY $2.3 BILLION IN 1981, NEARLY ONE HALF OF THE TOTAL UNREPORTED INCOME IN THIS COMPONENT. MOST OF THE NONCOMPLIANCE HERE OCCURS BECAUSE OF OUR CURRENTLY "LOOSE" INFORMATION REPORTING AND WITHHOLDING REQUIREMENTS, WHICH ONLY REQUIRE EMPLOYERS TO REPORT AND WITHHOLD ON THE TIP INCOME VOLUNTARILY REPORTED TO THEM BY THEIR EMPLOYEES.

WE BELIEVE THE TIP AREA IS ONE THAT DESERVES OUR COLLECTIVE ATTENTION, AND WE ARE PLEASED THAT H.R. 5829 CONTAINS NEW REPORTING REQUIREMENTS IN AN ATTEMPT TO CLOSE THIS PORTION OF THE TAX GAP. WE BELIEVE THAT THERE MAY BE BETTER APPROACHES, HOWEVER, AND WE WILL BE WORKING WITH TREASURY TO DEVELOP SOLUTIONS. THIS IS AN EXCELLENT OPPORTUNITY TO ADDRESS A TROUBLESOME AREA, AND IT SHOULD NOT BE MISSED.

7. NONFILERS

THE TAX GAP COMPONENTS I HAVE DISCUSSED UP TO NOW HAVE MAINLY INVOLVED UNDERREPORTING IN RETURNS FILED. AN EQUALLY SERIOUS PROBLEM, HOWEVER, IS NONFILERS - THOSE WHO SIMPLY DO NOT FILE A RETURN, BUT SHOULD. THIS COULD BE ANYONE, ANYWHERE IN THE TAX SYSTEM.

THE TAX GAP FOR NONFILERS IS RESPONSIBLE FOR $4.9 BILLION OR 6 PERCENT OF THE TOTAL INDIVIDUAL TAX GAP. HOWEVER, THE TAX GAP FROM NONFILERS HAS GROWN 4 TIMES SINCE 1973 COMPARED TO ABOUT 3 TIMES FOR THE TAX GAP ON RETURNS FILED. CURRENT LAW IMPOSES A PENALTY FOR DELINQUENT FILING ONLY IF THE TAXPAYER OWES A TAX. MANY NONFILERS, HOWEVER, ARE EITHER OWED A REFUND OR OWE NO TAX. IN TRYING TO SECURE DELINQUENT RETURNS, WE CANNOT DISTINGUISH BETWEEN THOSE WHO OWE TAX AND THOSE WHO DON'T. THE IMPOSITION OF A MINIMUM PENALTY FOR FAILING TO FILE WOULD HELP ACHIEVE BETTER COMPLIANCE WITH THE FILING REQUIREMENTS AND SHOULD HELP OFFSET THE SUBSTANTIAL ADMINISTRATIVE COSTS OF LOCATING TAPAYERS WHO FAIL TO FILE FOR THEIR REFUNDS.

ANOTHER ASPECT OF THE NONFILING PROBLEM IS THAT CREATED BY ILLEGAL TAX PROTESTORS. THESE INDIVIDUALS OFTEN FAIL TO FILE RETURNS AS A CONSCIOUS WAY OF PROTESTING

AGAINST THE TAX SYSTEM. ALTERNATIVELY, THEY FILE FRAUDULENT WITHHOLDING REQUESTS (FORMS W-4) TO REDUCE OR ACTUALLY ELIMINATE AMOUNTS TAKEN FROM THEIR SALARIES. THE NEW ECONOMIC RECOVERY TAX ACT PENALTY OF $500 FOR FILING FALSE W-4'S WILL CERTAINLY AID OUR ENFORCEMENT EFFORTS IN THIS AREA. HOWEVER, AS A RESULT OF OUR COMPLIANCE EFFORTS IN THIS AREA, A BURDEN HAS BEEN PLACED ON SOME EMPLOYERS WHO ARE NOW FINDING THAT BY COMPLYING WITH IRS WITHHOLDING INSTRUCTIONS, THEY ARE BEING SUBJECTED TO UNFOUNDED LAW SUITS BY THE PROTESTORS. I BELIEVE IT IS UNFAIR TO MAKE EMPLOYERS SHOULDER THE BURDEN AND EXPENSE OF THESE LAW SUITS AND IT SEEMS CLEAR THAT IRS AND JUSTICE DEPARTMENT EFFORTS TO ACT AS FRIENDS OF THE COURT ARE NOT ENOUGH. THEREFORE, I WOULD URGE THE COMMITTEE TO CONSIDER ADDING A PROVISION TO THIS LEGISLATION TO EFFECTIVELY DEAL WITH THIS PROBLEM. WE WOULD BE HAPPY TO WORK WITH YOU AND THE COMMITTEE STAFF ON THIS POINT.

8. CORPORATE TAX GAP

OUR RECENT WORK IN THE CORPORATE AREA HAS INDICATED THAT OUR MAJOR PROBLEM INVOLVES THE OVERSTATEMENT OF EXPENSES, DEDUCTIONS, AND CREDITS. HOWEVER, ESTIMATES IN THIS AREA ARE EXTREMELY DIFFICULT TO DEVELOP. PRECISE NUMBERS WILL BE INCLUDED IN OUR FINAL REPORT.

THE SERVICE'S EFFORTS IN THIS AREA HAVE FOCUSED ON THE LARGE CORPORATIONS. VIRTUALLY ALL OF THEM ARE AUDITED ON A THREE YEAR CYCLE. FOR MANY SMALL CORPORATIONS, HOWEVER, THE EARLIER DISCUSSION ON THE "AUDIT LOTTERY" AND THE NEED TO INCREASE THE RISKS FOR PLAYING THE "AUDIT LOTTERY" APPLY EQUALLY AS WELL HERE AS IN THE PARTNERSHIP AREA.

9. ILLEGAL SECTOR

OUR ESTIMATES OF THE ILLEGAL SECTOR WERE DEVELOPED IN CONJUNCTION WITH WORK OF THE NATIONAL NARCOTICS INTELLIGENCE CONSUMERS COMMITTEE (NNICC), AND INCLUDE THE TAX GAP FROM ILLEGAL DRUGS, GAMBLING AND PROSTITUTION. WE ARE WORKING TO DEVELOP ESTIMATES IN OTHER AREAS, SUCH AS WHITE COLLAR CRIME, BUT DO NOT KNOW WHEN WE WILL HAVE USABLE RESULTS.

BECAUSE PRECISE ESTIMATES IN THIS SECTOR ARE DIFFICULT TO OBTAIN, WE CAN ONLY ESTIMATE WITHIN A RANGE OF POSSIBILITIES. THE ESTIMATED TAX GAP FOR THIS ILLEGAL SECTOR IS BETWEEN $6 - $10 BILLION IN 1981, COMPARED TO $2 - $3 BILLION IN 1973. MOST OF THIS INCREASE IS DUE TO AN INCREASE IN THE INCOME FROM ILLEGAL DRUGS.

We endorse your efforts to provide the Service better administrative tools for working in this area. We are especially pleased by the changes in the administrative summons provisions. The changes will enable the Service to move much more quickly against those who refuse to comply with our tax laws.

10. Foreign Sector

At the present time, the Service has no estimate of the extent of the tax gap attributable to taxpayers owning overseas businesses or investments. One of the principle reasons for this has been the inability of the Service to adequately examine the books and records of many offshore enterprises. This is particularly true for businesses operating in so-called tax haven countries. Given this situation, the increased penalties of H.R. 6300 for those taxpayers who refuse to cooperate with the IRS when it requests books and records are needed.

Effective Dates

Many of the provisions of this legislation will have wide-ranging impacts on both the private sector and the Service. In particular our administrative data processing operations will be affected. Efficient implementation of your proposals will require that adequate lead time be

PROVIDED ALL CONCERNED PARTIES - REGARDLESS OF WHAT THE EXACT DATES ARE. WE WILL BE PLEASED TO WORK WITH YOU AND THE COMMITTEE STAFF AS NECESSARY TO REFINE THE NECESSARY LEAD TIMES INVOLVED.

REVIEW OF COMPLIANCE TECHNIQUES

WITHOUT QUESTION, THE SINGLE MOST EFFECTIVE AND FAIREST MEANS OF CLOSING THE TAX GAP AND INSURING HIGH LEVELS OF COMPLIANCE IS WITHHOLDING AT THE SOURCE. IRS ESTIMATES INDICATE THAT WHERE THERE IS WITHHOLDING, COMPLIANCE IS IN THE 97-99 PERCENT RANGE.

INFORMATION REPORTING IS THE NEXT MOST EFFECTIVE APPROACH FOR ENSURING HIGH LEVELS OF INCOME REPORTING COMPLIANCE, BUT ONLY WHEN THE TAXPAYER RECEIVES A COPY OF THE INFORMATION REPORT AND WHEN COMPLEMENTED BY IRS MATCHING AND ENFORCEMENT PROGRAMS. AS I HAVE DISCUSSED ABOVE, THERE ARE CLEARLY ADDITIONAL AREAS TO WHICH THE CONCEPTS OF INFORMATION REPORTING CAN BE EXTENDED. WHERE INFORMATION REPORTING ALONE IS RELIED ON, COMPLIANCE DROPS TO SOMETHING LESS THAN 90 PERCENT.

TO ENSURE THE FULL EFFECTIVENESS OF INFORMATION REPORTING TO THE SERVICE, HOWEVER, SEVERAL OTHER FACTORS MUST BE CONSIDERED. FIRST, THE INFORMATION SHOULD ALSO BE SENT TO THE PAYEE. UNLESS A COPY OF WHAT WAS SENT TO THE IRS REACHES THE TAXPAYER AT THE TIME HE OR SHE COMPLETES THE RETURN, IT CAN TOO EASILY BE FORGOTTEN.

SECOND, THERE MUST BE EFFECTIVE PENALTIES ON PAYERS TO ENSURE THAT ALL INFORMATION IS IN FACT REPORTED AND THAT THEY OBTAIN CORRECT TAXPAYER IDENTIFICATION NUMBERS FROM THE PAYEES. AS I DISCUSSED EARLIER, OUR MOST RECENT RESEARCH INDICATES THAT THERE CURRENTLY IS A SUBSTANTIAL DEGREE OF NONCOMPLIANCE BY PAYERS WITH THE PRESENT REPORTING REQUIREMENTS. WHILE WE ARE TAKING STEPS ADMINISTRATIVELY TO BEGIN TO DEAL WITH THIS PROBLEM, THE ADDITIONAL PENALTIES IN THE BILL ARE NEEDED.

A THIRD FACTOR THAT IMPACTS ON OUR ABILITY TO USE INFORMATION RETURNS IS THE FORMAT IN WHICH IT IS SUBMITTED TO US. IF THE INFORMATION IS SENT ON MAGNETIC MEDIA, WE ARE GENERALLY ABLE TO MATCH 100 PERCENT OF THE INFORMATION; BUT IF IT IS SENT ON PAPER DOCUMENTS, THE PERCENTAGE WE ARE ABLE TO MATCH IS FAR LOWER. WE HAVE BEEN QUITE SUCCESSFUL IN GETTING BUSINESSES TO USE MAGNETIC MEDIA ON A VOLUNTARY BASIS, BUT BELIEVE THAT GIVING THE SERVICE THE AUTHORITY TO SET STANDARDS IN THIS AREA WILL IMPROVE SUBSTANTIALLY OUR ABILITY TO ADMINISTER THE INFORMATION RETURNS PROGRAM IN THE FUTURE.

WHERE NEITHER WITHHOLDING NOR INFORMATION REPORTING IS PRESCRIBED, AND IRS MUST RELY ON ITS AUDITING EFFORTS ALONE, COMPLIANCE IN THE RANGE OF 60-80 PERCENT CAN BE EXPECTED. TRADITIONAL EXAMINATION ENFORCEMENT EFFORTS SHOULD, IN MY VIEW, BE LIMITED TO THOSE AREAS WHERE THEY ARE THE MOST PREFERABLE OR THE ONLY AVAILABLE OPTION.

SUMMARY

TO AN EXTENT, TAX GAPS CAN BE CLOSED BY MORE EFFECTIVE ENFORCEMENT AND BY A COMMITMENT OF ADDITIONAL ENFORCEMENT RESOURCES. A SIGNIFICANT PORTION OF THE GAP, HOWEVER, IS SIMPLY NOT AMENABLE TO TRADITIONAL EXAMINATIONS AND AUDITS.

ALL THINGS CONSIDERED, EXTENSION OF WITHHOLDING PROVISIONS PROVIDE THE SUREST WAY OF CLOSING CERTAIN TAX GAPS. EXPANDED INFORMATION REPORTING WITH APPROPRIATE PENALTIES CAN ALSO BE VERY EFFECTIVE, PARTICULARLY AS IRS FURTHER EXPANDS ITS ADP CAPABILITIES.

ADDITIONAL OR INCREASED PENALTIES WHICH REFLECT CURRENT ECONOMIC REALITIES AND DETER CURRENT FADISH FORMS OF NONCOMPLIANCE ALSO CLOSE THE DOOR QUICKLY ON CERTAIN TAX GAP PROBLEM AREAS.

AGAIN, I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE THIS COMMITTEE. I HOPE I HAVE GIVEN YOU A CONTEXT FOR OUR POSITION AND I WILL LEAVE IT UP TO MR. CHAPOTON TO DISCUSS THE SPECIFIC PROVISIONS OF YOUR PROPOSED LEGISLATION.

ATTACHMENTS TO STATEMENT OF ROSCOE L. EGGER, JR. BEFORE THE WAYS AND MEANS COMMITTEE.

ATTACHMENT I	DIFFERENCE BETWEEN THE 1979 UNREPORTED INCOME REPORT AND THE NEW TAX GAP REPORT TO BE PUBLISHED THIS SUMMER
ATTACHMENT II	GROSS TAX GAP FROM INDIVIDUAL INCOME TAX RETURNS FILED, NONFILERS, CORPORATE TAX AND ILLEGAL SECTOR, TAX YEARS 1973, 1976, 1979, AND 1981

DIFFERENCES BETWEEN THE 1979 UNREPORTED INCOME REPORT[1] AND THE NEW TAX GAP REPORT TO BE PUBLISHED THIS SUMMER

1. The tax gap analysis is based on a different concept from the unreported income approach of the 1979 Unreported Income Report. Consequently, both the numbers and the discussion of noncompliance relating to these concepts will differ. The current tax gap analysis, as the name implies, focuses on taxes which should be paid but are not, whether due to underreported income or overstated expenses, exemptions, deductions or other reasons. The focus of the 1979 Report was only on unreported income and its associated tax gap. The current emphasis is on the tax administration aspects of total taxes not paid--including discussions of both problems and possible solutions--not just an estimation of the tax gap associated with unreported income.

2. The new tax gap report has a different definition of unreported income from that of the Report. The Report uniformly used "net income," i.e. receipts minus all expenses and consequently included overstated business expenses as underreported income. The report generally uses gross profit (gross receipts minus cost of goods sold) as the measure of income and shows overstated expenses separately.

   Another difference in the definition of unreported income is that the current tax gap analysis shows estimates of unreported income on which tax is due (i.e., where the income is not offset by excess deductions, exemptions, credits or the tax on which is not offset by withholding) for both filers and nonfilers. The Report had reduced total unreported income by nominal amounts (with no tax consequence) only for nonfiler wages.

3. The new tax gap report also includes the corporate income tax. The previous Report dealt only with the individual income tax.

4. A new method was used in the current tax gap analysis to estimate unreported income not found by TCMP. For most items, the TCMP amount was multiplied by 3.5 to obtain the total unreported income. The ratio of unreported IRP-covered income to the amount discovered by TCMP for those items for which IRP documents were filed and available was found to be about 4.5 to 1 in a 1976 TCMP/IRP study. The multiple of 3.5 mentioned above is a conservative version of the multiple of 4.5 found in this study. The rationale of applying this ratio across the board is that if TCMP can find only $1 out of $3.50 on items for which information documents exist, it would do no better for other income items. The 1979 Report derived the non-TCMP unreported income estimates from BEA and other data sources.

---

[1] Estimates of Income Unreported on Individual Income Tax Returns, September, 1979.

5. **The illegal-source estimates** of unreported income are lower in the current version. In the area of illegal drug trafficking, the estimates were lowered when a review by an independent research organization concluded that the high National Narcotics Intelligence Consumers Committee (NNICC) estimates of consumption at retail prices on which the prior estimates of unreported income were based could not be justified. The estimated unreported income of those organizing illegal gambling enterprises were lowered after the FBI withdrew its endorsement of its high estimates of gross wagers used in the previous Report. A second, more important, reason for the downward revision of the illegal gambling estimates was the recommendation by an independent research group to base our estimates on a survey conducted by the University of Michigan, which previously had been thought to yield estimates that were too low.

6. The tax gap analysis was based on estimates of nonfiler incomes from Exact Match Files for 1977 as well as 1972. For the previous Report no data had yet been generated from the 1977 Exact Match File. Moreover, some errors in the previous estimates were discovered and corrected.

7. The tax gap analysis estimate of informal suppliers is based on recent University of Michigan survey data which were generated specially for the tax gap analysis. The prior estimates did not have a strong empirical base.

8. The tax gap analysis covers tax years 1973, 1976, 1979 and 1981. The 1979 Report covered only 1976.

Gross Tax Gap from Individual Income Tax Returns Filed, Nonfilers, Corporate Tax and Illegal Sector, Tax Years 1973, 1976, 1979 and 1981
(Amounts in Billions of Dollars)

	Amount of Tax Gap			
	1981	1979	1976	1973
Legal sector, total	87.2	66.5	42.6	29.3
Individual income tax returns, total	83.3	61.8	39.0	26.5
Filed returns, total	78.4	58.4	36.8	25.3
Income underreported:				
Wages	2.5	1.8	.7	.6
Tips	2.3	1.7	1.4	.9
Dividends	3.6	3.1	1.5	.9
Interest	4.1	2.9	1.3	.9
Capital gains	9.1	8.5	5.1	2.0
Nonfarm business	26.2	17.5	11.6	9.6
Farm business	1.4	1.7	1.7	1.5
Pensions	2.8	2.3	1.1	.7
Rents	1.5	1.2	.6	.4
Royalties	1.3	.8	.4	.1
Partnerships	5.5	3.1	2.5	1.5
Estates and trusts	.5	.4	.3	.2
Small business corporations	1.7	1.2	1.2	.4
State income tax refunds	.4	.3	.1	.1
Alimony	.1	*	*	*
Other	3.1	2.4	1.0	.6
Total	66.1	49.0	30.6	20.5
Overstated expenses, deductions credits[1]	12.3	9.4	6.2	4.8
Nonfilers	4.9	3.4	2.2	1.2
Corporate Tax	3.9	4.7	3.6	2.8
Illegal sector, total[1][2]	6.1- 9.8	4.6- 7.4	2.5- 4.0	1.8- 2.9
Drugs	4.5- 8.1	3.2- 6.0	1.4- 2.7	1.0- 2.0
Gambling	0.6- 1.2	0.5- 0.9	0.4- 0.7	0.3- 0.5
Prostitution	0.4- 1.2	0.3- 1.0	0.3- 1.0	0.2- 0.7

---

[1] These are preliminary IRS figures and have not been reviewed by the Office of Tax Analysis.

[2] Total of three items below and does not include any other illegal activities.

*Less than one hundred million

Note: Details may not add to totals because of rounding.

Chairman **Rostenkowski**. The Chair recognizes Mr. Conable.

Mr. **Conable**. Thank you. I apologize for intruding at this point, but I did want to make an opening statement also.

I was late arriving.

It is simply to put in context some of the issues that I see here which I am sure you will be addressing also, Mr. Archer. I appreciate the Chairman recognizing me. I do not think the importance of today's hearings should be underestimated. So-called compliance gap has increased from an estimated $31.5 billion in 1973 to an estimated $96 billion in 1985. Excuse me, from 1973, $31 billion, to an estimated $96 billion in 1981.

That is a 300-percent gain over an 8-year span. If the estimates are even close, the compliance gap is in the same league as the projected deficit in the Federal budget next year. Considering the problems we face in attempting to deal with that deficit, the importance of this issue looms large indeed. Both the bills which form the focus of today's hearings, my bill, H.R. 5829, also sponsored by Senator Dole, and H.R. 6300, introduced by the chairman, result from extensive cooperative effort by the staffs of the tax writing committees, IRS, and Treasury.

While there is no agreement on certain aspects of these measures, and I should emphasize that I am not entirely satisfied with all the provisions of the bill which I sponsored, I believe they represent a commendable effort to deal with a national problem of increasing significance. I am anxious to hear the testimony of today's witnesses. I hope they will include constructive recommendations for improvement.

I would like to comment briefly on two differences between H.R. 6300 and H.R. 5829. The first concerns compliance with respect to tips, which is a class of income with a compliance rate of less than 20 percent, the lowest for any class except illegal income. My bill, H.R. 5829, requires reporting with respect to charged tips as an additional attempt to raise the existing compliance rate. H.R. 6300 contains no provision dealing with this problem.

I realize it is an extremely controversial subject, but I do not feel we should ignore it.

The second difference on which I would like to comment concerns new information reporting provisions applicable to independent contractors and direct sellers contained in H.R. 6300. H.R. 5829 contains no comparable provisions, because I believe the overall independent contractor issue, including the critical question of when an individual is properly classified as an independent contractor rather than as an employee, should be addressed as a separate issue.

As a result, I have introduced, along with our colleagues, Dick Gephardt, Cec Heftel, and Kent Hance, H.R. 6311, which addresses the complex independent contractor issue in a comprehensive way. I am pleased to note that Chairman Stark of the Select Revenue Measures Subcommittee has scheduled this and other related bills for hearing on June 11, 1982.

Mr. Chairman, I am pleased that you are holding these hearings. I do believe the time is late for us to get at it, and I am very anxious to get all the testimony that is available on the subject today. Thank you.

Chairman ROSTENKOWSKI. Thank you, Mr. Conable.

Mr. Chapoton, you may proceed.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you, Mr. Chairman.

I am pleased to be here to present the Treasury Department's views on H.R. 6300 and H.R. 5829. In March of this year, Senators Dole and Grassley, with other cosponsors, introduced S. 2198. H.R. 5829 is the companion measure introduced in the House by Mr. Conable. I want to express our pleasure with the efforts made in these bills to face the difficult issues involved in the tax gap that Commissoner Egger's testimony has described.

Since those bills were introduced, further refinements have been made in the provisions in those bills and in other areas, particularly foreign transactions and illegal activities, and those changes are reflected in H.R. 6300, introduced by the chairman. We feel both of these bills, H.R. 5829 and H.R. 6300, are welcome measures, and that they can reduce significantly the tax gap that is of concern to us all. Both of these bills address a wide range of the compliance issues.

My written statement is quite lengthy. I will this morning summarize only a few of the more significant provisions in both of the bills, H.R. 6300 and H.R. 5829, and I will use as my organizational format H.R. 6300, because it does include the larger number of provisions.

Title I of H.R. 6300 deals with crimes, abusive tax shelters, and fraud. The first provision relates to jeopardy assessments by the Internal Revenue Service. Under current law, IRS may make a jeopardy assessment or termination assessment of tax when it believes the collection of tax will be jeopardized by delay.

Since jeopardy assessment procedures are premised on the Secretary's determination of a deficiency, the procedures do not work well in two situations, one, where a person is in control of cash derived from an illegal activity, and two, the situation where an individual is in possession of a large amount of cash but denies that he or any readily identifiable person owns the cash. H.R. 6300 would deal with both of these situations, creating a presumption that the cash constitutes gross income and that the collection of tax thereon will be jeopardized by delay.

We support these provisions. We think the presumptions established in the bill are logical, and should prove of substantial benefit to the IRS in dealing with illegal sources of income. We think the situations in which the presumptions arise are drawn narrowly enough so as not to sweep in the conduct of law abiding citizens. We would suggest that it might be more consistent to impose the $10,000 floor that is applicable in the illegal source income to also the case where the individual is in possession—excuse me, the $10,000 floor that is now applicable in the bill where the person is in possession of cash that he does not identify as his own, we think that might also apply in the first case, that is, where there is an IRS determination that illegal cash is involved. We think a $10,000 floor, in other words, is appropriate in both instances.

Another provision of this title deals with registration of debt obligations. Under current law, only certain categories of tax-exempt obligations are required by the tax law to be issued in registered form. Other obligations, whether taxable or tax exempt, may be issued in registered or bearer form in the issuer's discretion. The requirement of registration is well suited to preventing tax avoidance and evasion, most importantly, because it enables taxable obligations to be subject to information reporting in a much more accurate and comprehensive manner, but second, because both taxable and tax exempt obligations in bearer form are used as a medium of exchange in the illegal sector. From the viewpoint of revenue, these obligations may represent untaxed income. The absence of any system of recorded ownership makes it very difficult for the IRS to reconstruct the income of persons engaged in illegal activities in order to collect taxes due. Finally, we are concerned about the use of bearer obligations for the evasion of estate and gift taxes again because there is no record ownership.

H.R. 6300 will require that three classes of obligations be maintained in registered form: one, all obligations of the United States or any agency or instrumentality of the United States; second, all obligations bearing interest that is exempt from Federal tax; and, third, taxable obligations of a type offered to the public other than those having a maturity at issue of less than 1 year.

The sanctions provided by H.R. 6300 would be, in the case of a tax-exempt obligation, if it were not registered, the interest would not be tax exempt, and in the case of a taxable obligation, if it were not registered, the interest deduction would not be available absent registration. These registration requirements of H.R. 6300 are far reaching, but in our view they are appropriate. It is our understanding that many issuers of obligations prefer a registration system because it reduces insurance and handling expenses, even though some expense may be involved in recording ownership of obligations. We understand that a book entry system which is specifically approved as satisfying the registration requirement of H.R. 6300 is the type of current technology that has reduced the cost of maintaining ownership records substantially.

The Treasury Department's Bureau of Public Debt is an example. They have found it appropriate to switch from bearer T bills to a book entry system. There has been concern from time to time expressed about requiring registration of tax-exempt obligations, but we think those concerns are not overriding. Indeed we have some experience with registration of tax-exempt obligations; single family housing bonds have been required to be issued in registered form since the first of this year. We think that system is working reasonably well, and we think that it is certainly appropriate to require registration in the case of tax-exempt obligations.

We do have a couple of reservations about particular provisions dealing with registration in H.R. 6300. As one example, the bill would override treaty tax exemptions if an obligation were not registered. It would not be entitled to tax exemption even though a treaty would otherwise provide for exemption of interest on such an obligation. We do not think we should override treaty provisions that have been negotiated on the basis of a mutual interest exemption. Tax treaties extend benefits to our treaty partners because of tax concessions granted to our own taxpayers, and we do not think it is appropriate to override that negotiated type of arrangement.

In addition, we think the registration rules should not apply to any obligations, including obligations issued by the United States or an agency or instrumentality, if held by a person who is neither a U.S. citizen nor a resident of the United States, regardless of whether a treaty governs the taxability of the interest.

So, let me just restate that we support the registration requirement in general. We think there will be some technical imperfections in any broad change such as this and we want to work with the committee to resolve some of our technical concerns.

Another provision in H.R. 6300 deals with abusive tax shelters. We have, this committee and the Treasury, been worried about the proliferation of abusive tax shelters and tax evasion schemes in recent years. Traditionally, tax penalties have been keyed to the deficiency on the return of the filer. Abusive tax shelters, however, have generated substantial revenues to promoters who are untouched by the penalties on the investor.

At present, the IRS only has criminal sanctions to deal with the promoter of abusive tax shelters. H.R. 6300 would provide a civil penalty for promotion of abusive tax shelters as well. It would also allow IRS to proceed in court to obtain an injunction against persons who have engaged in conduct that would give rise to the imposition of the penalty for promotion of abusive tax shelters. The injunction could be issued if the court believed that injunctive relief is appropriate to prevent recurrence of such conduct.

We think these sanctions are appropriate, Mr. Chairman. The penalty for promotion of abusive tax shelters would apply to persons who organize an investment plan or arrangement that has an effect on Federal tax liability if the person either knowingly makes a false or fraudulent statement concerning a tax benefit of the offering or makes a gross valuation overstatement—a statement as the value of the property or services that exceeds the correct value by more than 200 percent.

So, we think those are appropriate cases. We think it is appropriate to have a civil penalty. We think it is appropriate to deal with the promoter. We also think the injunctive rules are welcome, because under current law the IRS must wait until a taxpayer who has invested in the shelter has filed his tax return. In the meantime, the promoter may have proceeded to sell the shelter to others. We think that where the court finds that there is a likelihood of recurring conduct, an injunction may well be the only effective means of preventing promoters from organizing and selling new abusive tax shelters.

The next provision I would like to mention is the penalty for documents understating tax liability. Present law provides a criminal penalty for willfully aiding or advising in the preparation of false or fraudulent returns; it also provides a penalty for tax preparers preparing false or fraudulent returns. H.R. 6300 would provide a civil penalty that closely parallels the criminal sanctions. The companion provision of H.R. 5829 applies a penalty to the fraud of a corporate officer, director, employee, or agent if that person knowingly participates in the fraud of a corporation. The penalty on the individual in that case would be 50 percent of the corporate underpayment caused by the fraudulent act, but not to exceed $100,000.

We think some type of civil sanction is appropriate in these cases, and we do not think it should be limited to the corporate situation. We are pleased that both bills contain a civil penalty for participating in the fraud of another for the reasons I outline in more detail in my written statement. We do prefer the approach of H.R. 6300. One of the reasons is, we are concerned about the magnitude of the penalty that might be imposed, the $100,000 ceiling in H.R. 5829, and we also like the broader scope of the H.R. 6300 provision.

Title II of the bill deals with information reporting, Mr. Chairman. Presently the law requires $10 or more of interest to be reported on corporate obligations issued in registered form. Because of the sweeping registration requirements in H.R. 6300, information reporting would be required under this bill in the case of virtually all obligations issued to the public after 1982. No reporting would be required with respect to tax-exempt obligations, however.

H.R. 6300 also introduces a couple of major changes in current law. It would require reporting on interest payments by the United States and its agencies and instrumentalities. Second, reporting would be required on interest paid on bearer obligations of the type issued to the public, except for obligations of less than a year in the case of those obligations held by corporate holders.

We applaud the efforts to fill these gaps that now exist in the information reporting rules. We do have some concerns about the implementation of such a broad system of reporting, that it might have some unexpected effects that we discuss in the written statement, and we would like to explore these further with the committee.

In the case of information reports to nonemployees, particularly the direct sale industry, both bills would expand information reporting. We have examined this area in great detail. Just to summarize—we would, as we stated before the Senate Finance Committee—support a reporting requirement of the name, address, and taxpayer identification number in every case where direct sellers have purchases in excess of $100 annually. We are convinced the IRS can use this information in a meaningful way, and it would not be burdensome to the direct sales industry.

In the case of charged tips, I just want to mention, Mr. Chairman, there is no provision in H.R. 6300. H.R. 5829 does have a provision dealing with charged tips, attempting to require information reporting where there is a paper record already in existence. In that case, it does seem the paperwork burden would not be too significant, and it does seem that information reporting would be appropriate.

We would want to mention, however, that the Internal Revenue Service has been working on a presumption of a presumed level of tip income for certain industries, a presumed percentage of gross receipts of the employer in the case of restaurants, for example. We think that approach might be worth pursuing, and we would like to look at it in a good deal more depth. The noncompliance in the tip area is a very serious problem, and we think that it must be dealt with.

Both bills, Mr. Chairman, would eliminate the oversight by the Office of Management and Budget over certain Treasury functions, particularly those discharged by IRS under the Paperwork Reduction Act of 1980. We have carefully considered these proposals within the administration. The administration is committed to the reduction of the paperwork burden where possible, including those that may be imposed by IRS and Treasury. Therefore, we think OMB oversight on paperwork is appropriate, and we are, as we did in the Senate, opposing elimination of the paperwork oversight provision in both of these bills.

Title III deals with pension and retirement income. Both H.R. 6300 and H.R. 5829 would impose reporting requirements on employers who maintain deferred compensation plans and will permit voluntary withholding. The major differences between the two bills relate to recordkeeping requirements and the withholding imposed on lump sum distributions.

In the recordkeeping area, H.R. 6300 would require a person who has a duty to report on pension plan distributions to maintain a data base consistent with that required for the later reports, and would impose penalties for failure to do so. We have some concern about that penalty, since there will be a penalty if the plan administrator does not furnish the correct information when the distribution is later made. We have some concern about an additional penalty for failure to keep records at the earlier date.

H.R. 6300 would also increase the penalty on early withdrawals from IRA's [Individual Retirement Accounts], from the present 10 to 15 percent. We would at this time oppose an increase in that penalty provision. While we certainly support the idea that IRA's are to be held for retirement, we are concerned that an increase in the penalty might discourage the broader use of individual retirement accounts, while not discouraging people who go into it as a tax shelter type arrangement, and so we have some concern about increasing that penalty until we see further whether that might discourage the creation of individual retirement accounts.

Title IV deals with transactions outside of the United States. Title IV of H.R. 6300 is intended to bolster in many instances and to simplify in many instances the present enforcement and reporting provisions. We are basically in support of all of the provisions in this title, with a couple of exceptions mentioned in our written statement. One of the provisions would require a taxpayer to come forward with records when requested—records that are abroad when requested by the Internal Revenue Service—and if it does not do so within a 90-day period, which could be extended in the discretion of the Commissioner, then that taxpayer would be precluded from later presenting these records to support his position in court.

We think this is an appropriate provision, particularly given the exception that a taxpayer could demonstrate that there was a reasonable cause for his failure to comply with the document request.

In addition to restricting the admissibility of evidence where a taxpayer fails to comply with a document request, however, H.R. 6300 would provide a presumption that deductions or credits purported to arise from a foreign transaction to which a document request relates are not allowable. We think that restates existing law, and would simply codify current law. Therefore, if such a provision is enacted or adopted in H.R. 6300, we would hope that the congressional report would make it clear that this is simply a codification of current law.

Title V deals with the modification of the interest provisions. The only change I would like to mention in that context is the substantial understatement penalty. This is a very important change that would be adopted by H.R. 6300, and a companion provision is in H.R. 5829. Both provisions deal with the small percentage of taxpayers who take overly aggressive positions on tax returns, relying on the relatively small audit coverage and the fact that the penalties will not be imposed if they can show that there was a reasonable basis for the position taken in the return.

H.R. 6300 would impose an additional nondeductible penalty equal to 20 percent of the interest payable on an underpayment of tax that results from a substantial understatement. A substantial understatement would be defined as one that results in tax liability of the greater of 10 percent, but at least $5,000, or 50 percent of the tax liability and at least $500. The IRS would have the authority to abate the penalty in whole or in part if there were a reasonable basis for the underpayment and the taxpayer acted in good faith.

The approach of H.R. 5829 would be to impose a 10-percent penalty on understatement of tax liability if the understatement were 10 percent but at least $5,000, $10,000 in the case of a corporation.

The main difference is, H.R. 5829 provides that if there is adequate disclosure on the tax return, the penalty will not be applied, whereas 6300 gives no automatic out where there is adequate disclosure. We have reviewed these provisions in great detail. We on balance think that the automatic exemption from a penalty based on disclosure is not administratively feasible because it is simply too hard to determine where there is adequate disclosure, but we would think that in exercising the authority of the IRS to abate a penalty, it would certainly be appropriate to take disclosure into account in determining the taxpayer's good faith.

Although this is a major change in the tax law, we would support a type of automatic penalty in concept. We do want to consider this matter further with the committee, and we would certainly want to make certain that the abatement procedures are adequate to deal with taxpayers who have acted in good faith.

Finally, Mr. Chairman, title VI deals with the tax treatment of partnership items and subchapter S items. This title in the partnership area is the result of a long and determined effort on the part of the Internal Revenue Service, the Treasury Department, and the staffs of both tax writing committees. Consultation has been had with various bar associations and the accounting groups. Basically the partnership audit provisions of the bill would impose improved enforcement of the tax laws in a manner we think that would be fair and equitable and we think this deserves all of our support.

A similar provision deals with subchapter S corporations which would require that the tax treatment of any item be determined at the corporate level, and would require the consistent treatment of the item on the taxpayer's return unless he filed a specific statement identifying the inconsistency in the shareholder's return. We think these are good changes and we strongly support both of them.

The revenue estimates of these very far-reaching bills, Mr. Chairman, are still being worked on by our Office of Tax Analysis. They will be available within a matter of 2 or 3 weeks, and they will be supplied as soon as they are available.

Thank you, Mr. Chairman.

[The prepared statement follows:]

STATEMENT OF HON. JOHN E. CHAPOTON

Mr. Chairman and Members of this Committee:

I am pleased to be here today to discuss the provisions of H.R. 6300, the "Tax Compliance Act of 1982," and H.R. 5829, the "Taxpayer Compliance Improvement Act of 1982." We view these bills as laudable steps towards improving compliance with our tax laws.

Overview

In March of this year, Senators Dole and Grassley, with other co-sponsors, introduced S. 2198. The companion measure, H.R. 5829, was introduced in the House by Mr. Conable. We were pleased with the efforts that were made in those bills to face the difficult issues presented by the compliance tax gap that Commissioner Egger has described. Since those bills were introduced, more work has been done to refine some of the approaches taken in the bills and to enlarge the scope of the measures -- particularly into the areas of abusive tax shelters, foreign transactions, and illegal activities. H.R. 6300, introduced by Mr. Rostenkowski, is the product of these further efforts. We feel that H.R. 5829 and H.R. 6300 are welcome measures that can reduce the compliance tax gap and strengthen our self-assessment tax system.

R-783

Both of these bills address a wide range of compliance issues that confront us today. I will in this statement indicate our views on the various provisions contained in these bills. I will use as the organizational format of my statement the sequence of the provisions of H.R. 6300 only because that bill includes the larger number of provisions.

TITLE I--CRIMES, ABUSIVE TAX SHELTERS, FRAUD, ETC.

Jeopardy Assessments

Under present law, the IRS may make a jeopardy or termination assessment of tax when it believes that the collection of tax will be jeopardized by delay. A jeopardy assessment may be employed, for example, if a taxpayer intends to conceal himself or his property, to remove his property from the United States or to dissipate his property. Although the jeopardy and termination assessment procedures may be completed very rapidly, the taxpayer has the right to immediate review by the IRS of both the reasonableness of an assessment and the appropriateness of the amount assessed. The taxpayer is also entitled to review by a United States District Court.

The jeopardy and termination assessment procedures are premised upon the Secretary's determination of a deficiency. As a result, these procedures are not well suited to dealing with two situations: (1) the case where a person is in control of cash derived from or used in an illegal activity, and (2) the situation where an individual in possession of large amounts of cash denies that he or any readily identifiable person owns the cash. The latter case suggests quite clearly that the cash has been derived from or used in illegal activities. In both of these situations, the inability of the IRS to determine the person's tax liability immediately prevents it from reaching this cash under the jeopardy and termination assessment procedures.

H.R. 6300 would, in these two situations, create a presumption that the cash constitutes gross income and that collection of tax due thereon will be jeopardized by delay. The bill provides that this presumption will arise in the situation in which a person possesses, controls or deposits cash, or has recently done so, and the Secretary believes the cash represents gross receipts from or funds used in an illegal activity -- defined as an activity punishable by imprisonment. The presumption will also arise if an individual in possession of over $10,000 cash denies ownership of the cash or identifies the owner, which cannot be readily verified. In the latter case, because the true owner may not (by definition) be identified, there would be a further presumption that the cash is taxable to a single individual at the 50 percent rate.

In any situation in which these presumptions come into effect, the taxpayer will retain the right to challenge the presumptions in court. Where a jeopardy assessment is made against a person possessing illegal source cash, he is initially entitled to an expedited review by the IRS of the existence of jeopardy and the appropriateness of the amount assessed. The assessment is also reviewable in court, with the burden on the Secretary to show that the determination of jeopardy was reasonable. Where cash is not claimed by the possessor and the owner is not identified, the true owner will have the rights that he has under present law to come forward and establish his ownership of the cash. H.R. 5829 does not address jeopardy and termination assessments.

We believe that the presumptions established by H.R. 6300 are logical and should prove of substantial benefit to the IRS in dealing with illegal source income. Moreover, we believe that the situations in which the presumptions arise are drawn narrowly enough so as not to sweep in conduct of law-abiding persons. However, we feel that it would be consistent to impose a $10,000 floor in both situations. We understand that concern has been expressed about potential IRS harassment of individuals with small amounts of cash. Although we think that this concern is unfounded, a $10,000 floor would help to alleviate these fears. We believe that this change, coupled with the remedies now in the bill in the case of any improper assessment, should fully assuage any concern that these presumptions might be applied unjustly. We therefore support these provisions.

Reporting on Transfers of Currency to Points Outside the United States

Under present law, a report is required to be filed with the IRS by a financial institution with respect to each deposit, withdrawal, exchange of currency or other payment to or through a financial institution in excess of $10,000. Certain interbank and other business transactions are exempted. Present law also requires a person who transports currency or other monetary instruments in excess of $5,000 to a point outside the United States to file a report with customs officials.

Although intentional failure to comply with these requirements is punishable as a criminal offense, present law does not explicitly impose a penalty on persons who unsuccessfully attempt to avoid these reporting requirements. Enforcement of the reporting rules is difficult because the person violating the reporting requirement may be outside the United States when the violation occurs.

H.R. 6300 would in effect make it a crime to attempt to transport monetary instruments in excess of $5,000 to a point outside the United States without satisfying the currency reporting requirements. H.R. 5829 contains no parallel provision.

The Administration is examining the desirability of making it a criminal offense for attempts to violate the bank secrecy laws, of which these two provisions are a part. We will be happy to submit our views on these changes at a later time.

Registration of Obligations

Under current law, only certain categories of tax-exempt obligations are required to be issued in registered form. Other obligations, whether taxable or tax-exempt, may be issued in registered or bearer form, in the issuer's discretion.

The requirement of registration is well suited to preventing tax avoidance and evasion for several reasons. First, in the case of instruments that bear taxable interest, perhaps the most important reason for a registration requirement is that instruments in registered form lend themselves well to accurate and comprehensive information reporting. A system of information reporting on bearer instruments is more susceptible to manipulation by persons seeking to avoid information reports. Moreover, it is difficult to report taxable original issue discount to holders of bearer obligations as the discount accrues.

Second, both taxable and tax-exempt obligations in bearer form are used as a medium of exchange in the illegal sector. From the viewpoint of revenue, these obligations may represent untaxed income. The absence of any system of recorded ownership of such obligations makes it very difficult for the IRS to reconstruct the income of persons engaging in illegal activities in order to collect taxes due.

Finally, obligations in bearer form lend themselves to the evasion of estate and gift taxes, again because there is no record of ownership.

Notwithstanding the possibilities for tax avoidance and evasion that are inherent in bearer obligations, we are aware that short term commercial paper is in bearer form so that the obligations may change hands very rapidly. The participants in the commercial paper market are almost exclusively corporations, and our information is that the reporting of interest on these obligations does not represent a compliance problem.

H.R. 6300 would require that three classes of obligations be maintained in registered form: (1) all obligations of the United States or any agency or instrumentality thereof, (2) all obligations bearing interest

H.R. 6300 would require that three classes of obligations be maintained in registered form: (1) all obligations of the United States or any agency or instrumentality thereof, (2) all obligations bearing interest that is exempt from Federal tax, and (3) taxable obligations of a type offered to the public other than those having a maturity at issue of less than 1 year. Under H.R. 6300, interest on obligations that otherwise would be tax-exempt would be taxable if the registration requirement were not satisfied. The bill would override any provision of a tax treaty to which the United States is a party to the extent that the treaty allowed an exemption from tax of interest income on an obligation not issued in registered form. Issuers of taxable obligations required to be in registered form would lose their interest deduction if the registration requirement were not met. In addition, holders of obligations that do not satisfy the registration requirement would be denied any loss deduction on the sale or worthlessness of the obligation. These rules would apply to obligations issued after December 31, 1982. H.R. 5829 contains no parallel provisions.

The registration requirement of H.R. 6300 is far-reaching, but, in our view, appropriate to deal with the problem of tax evasion presented by the illegal sector and the clear need for a uniform and effective system of information reporting on taxable interest income. It is our understanding that many issuers of obligations prefer a registration system because it reduces insurance and handling expenses, even though some expense may be involved in recording ownership of obligations. Further, we understand that a book-entry system, which is specifically approved as satisfying the registration requirement of H.R. 6300, is the type of current technology that has reduced the cost of maintaining ownership records substantially. The Treasury Department's Bureau of Public Debt, as an example, found it appropriate to switch from issuing Treasury bills in bearer form to registering such obligations in a book-entry system.

We do not believe that requiring registration of tax-exempt obligations should impose undue costs or burdens on State and local governments. At present, single-family housing bonds as well as certain bonds issued to finance residential real property and energy are required to be issued in registered form. We understand that any increased registration costs that are encountered by issuers of bonds would be largely offset by lower insurance and other handling costs. The slightly lower trading price of registered bonds may well be due to the decreased value of these instruments in the illegal sector. If that is the reason, a broad-based registration requirement would eliminate any price disparity between registered and unregistered bonds.

We believe that, as drawn, the measure adequately takes into account the commercial paper market by excluding instruments with a maturity of 1 year or less from the registration requirement. In this regard, discount notes issued by Federal instrumentalities are similar to commercial paper and should be accorded similar treatment. Likewise, we feel it is important to be certain that other legitimate markets that may not have come to our attention will not have their operations impaired by this registration requirement.

We object to the provision of the bill that would override the many tax treaties that we have negotiated on the basis of a mutual interest exemption. Tax treaties extend tax benefits to our treaty partners because of tax concessions granted to our own taxpayers. To the extent that obligations may be issued to foreign persons who may be exempt from tax because of a tax treaty provision, there appears to be no potential for evasion of U.S. taxes, other than the problem of obligations being resold to U.S. persons. We therefore believe that provision should be deleted from the bill.

In addition, we think the registration rule should not apply to any obligations, including obligations issued by the United States or any agency or instrumentality thereof, issued to persons who are neither United States citizens nor residents, regardless of whether a treaty governs the taxability of the interest, again recognizing the problem with resale in the United States. However, it may be possible for a U.S. person to avoid the registration requirement by issuing debt obligations through a controlled foreign corporation established in certain countries with which the United States has tax treaties. We would like to work with the Committee to address these questions but in a way that would not affect access of U.S. borrowers to foreign capital markets.

Let me restate that we believe this registration requirement is a laudable step toward improved tax compliance. Any proposal of this scope will have technical imperfections, which we will work with you to resolve. Subject to the concerns that we have expressed, we support this provision.

Abusive Tax Shelters

The profileration of abusive tax shelters and tax evasion schemes in recent years has been a matter of substantial concern to the Treasury. Traditionally, tax penalties have been keyed to the deficiency on the return of the filer. Abusive tax shelters, however, have generated substantial revenues to promoters, who are untouched by penalties imposed on investors. At present, the IRS has only the criminal penalty for participation in the preparation of false tax documents and the return preparer penalty to deal with these problems. In many cases, promoters of abusive tax shelters are not tax return preparers as that term is defined in the Internal Revenue Code. In other cases, it is difficult to establish an intention to aid or assist in the preparation of a false or fraudulent tax return that would result in a criminal sanction.

H.R. 6300 would provide a civil penalty for promotion of abusive tax shelters. H.R. 6300 would also provide IRS with the authority to proceed in court to obtain an injunction against persons who have engaged in conduct that would give rise to imposition of the penalty for promotion of abusive tax shelters; such an injunction could be issued if the court believes that injunctive relief is appropriate to prevent recurrence of such conduct. Similar injunctive authority now exists in the return preparer area. H.R. 5829 contains no parallel provisions.

The penalty for promotion of abusive tax shelters would apply to persons who organize or assist in the organization of a partnership (or other entity), an investment plan or arrangement, or a plan or arrangement that has (or purports to have) an effect on Federal tax liability, as well as to a person who participates in the sale of such an entity, plan or arrangement, if the person either knowingly makes a false or fraudulent statement concerning a tax benefit of the offering, or makes a gross valuation overstatement. A gross valuation overstatement is defined as a statement as to the value of property or services that exceeds the correct value by 200 percent. The Secretary would have authority to abate a penalty imposed due to a valuation overstatement if there were a reasonable basis for the valuation and the taxpayer acted in good faith. Under the bill, the penalty would be the greater of $1,000 or 10 percent of the gross income derived by the person from the activity. The burden of proof in a court proceeding would be on the Secretary to determine whether the penalty provisions have been violated.

Our voluntary tax compliance system is jeopardized by abusive tax shelter schemes. Frequently, the persons who enter into such schemes are not aware that the scheme is inconsistent with the tax law. Therefore, the persons who promote such schemes and investments, being the persons most knowledgeable regarding the validity of the scheme or investment under the law, are appropriate targets of a penalty, and we support this provision.

We believe that the penalty must be applicable to a wide variety of investment plans and arrangements in order to be effective. The scope of the penalty is not, in our view, overly broad because it will apply only in the situation where the promoter makes a representation as to tax consequences of the investment that he knows or has reason to know is false or fraudulent as to any material matter, or where a valuation approaches fraud because it exceeds a reasonable estimate by a very wide margin.

We believe that the bill's injunction rules are also necessary, as in the return preparer area. IRS has at times successfully challenged an abusive tax shelter, only to find the promoter of the shelter has marketed additional abusive shelter schemes, which require separate audits and enforcement proceedings. This problem is particularly acute because the IRS generally must await the filing of a tax return -- sometimes long after the scheme has been sold -- even to begin its examination of the scheme. By that time, the promoter may have sold several new schemes. Where a court determines that there is a likelihood of recurring conduct, an injunction may well be the only effective means of preventing promoters from organizing and selling new abusive tax shelter schemes.

We strongly feel, however, that the venue of the injunction provision should be enlarged. The bill allows an injunction action to be brought in the district in which the promoter resides or has his principal place of business. If a promoter sells shelters by mail or employs salesmen in other states to market the shelter, the IRS cannot seek an injunction in those districts against the promoter, even though witnesses and documents would be present in those districts. Even the venue in the return preparer area may include the district in which the taxpayer with respect to whose income tax return the action is brought resides. We therefore think the venue in the promoter situation should be broadened to include any district in which the promoter is doing business.

Fraud Penalty

If any portion of an underpayment is due to fraud, present law imposes a civil penalty equal to 50 percent of the entire underpayment. If part of an underpayment is attributable to negligence or intentional disregard of rules and regulations not constituting fraud, the penalty is 5 percent of the entire underpayment, plus 50 percent of the interest payable on the portion of the underpayment due to negligence for the period beginning on the last date prescribed by law for payment of the tax and ending on the date of the assessment of the tax. The 50 percent of interest penalty in negligence cases was added by the Economic Recovery Tax Act.

H.R. 6300 would make the fraud penalty consistent with the negligence penalty by adding a penalty equal to 50 percent of the interest on the portion of the underpayment due to fraud. The fraud penalty would not apply in any case in which the negligence penalty was applicable. H.R. 5829 contains no parallel provision.

The impetus for this addition is the anomalous situation that could arise if a negligence penalty is imposed in a matter that has been pending for many years. In such a case the time-sensitive element of the negligence penalty could increase to the point that the total negligence penalty would be larger than the fraud penalty would have been. We agree that the two penalties should be consistent; therefore we support this provision.

Penalty for Documents Understating Tax Liability

Present law provides a criminal penalty for willfully aiding, assisting in, procuring, counseling or advising the preparation of a false or fraudulent tax return, affidavit, claim or other document under the internal revenue laws. In addition an income tax return preparer who willfully understates the tax liability of any person is subject to a penalty of $500 per return.

H.R. 6300 would provide a civil penalty that closely parallels the criminal sanction just described. It would apply to a person who aids, assists in, procures, or advises the preparation of a return, affidavit, claim or other document under the internal revenue laws which the person knows will likely be used in connection with a tax matter, and which the person knows will result in the understatement of tax of another person. The term "procures" is broadly defined to include ordering a subordinate (who need not be an employee) to do an act, or knowing of, and not attempting to prevent, a subordinate's participation in an act. The penalty would be $1,000 per person, and $5,000 per person in the case of corporate tax. In imposing the penalty, the burden of proof would be on the Secretary. The return preparer penalty would not apply to any person on whom this penalty was imposed.

H.R. 5829 provides a penalty that applies to the fraud of a corporate officer, director, employee, or agent if such person "knowingly participated" in the fraud of a corporation which resulted in an underpayment of tax by the corporation. The penalty would be an aggregate amount equal to 50 percent of the corporate underpayment caused by the fraudulent act, but not over $100,000 per individual. "Knowing participation" is generally defined to include the same acts and omissions that are included in the definition of "procure" in H.R. 6300.

At present, with the limited exception of the return preparer penalty, the IRS is without a civil sanction that may be used against corporate officers and other persons who participate in the tax fraud of another person. We support the addition to the Code of a civil penalty applicable to all persons who participate in tax fraud.

H.R. 6300 reconciles the potential overlap of this civil penalty with the return preparer penalty by providing that the return preparer penalty will not apply if the civil fraud penalty is imposed. We agree with that approach because the conduct proscribed by the two penalties is very similar. In addition, H.R. 6300 may result in a generally lower level of penalty then H.R. 5829, although comparison of the two bills on this question is difficult because the penalties are calculated so differently. It is our belief that a $100,000 penalty such as that contained in H.R. 5829 could be high in the case of low level employees. In the case of highly paid consultants and employees, we believe that a substantial stigma would attach if the penalty were imposed. Therefore we are not concerned that the "sting" would be eliminated by providing for a smaller monetary penalty.

In terms of the scope of the penalty, we do not think that it should be limited to corporate situations. We are also of the view that the standard of H.R. 6300 (the person "knows that such document (if so used) will result in an understatement") is preferable to the standard that is used in H.R. 5829 (the person "knowingly participated in any fraud which resulted in a part of any underpayment"). Although both standards would require a showing of fraud by the IRS, the latter standard may inappropriately apply to nontax fraud that results in an underpayment.

To reiterate, we are pleased that both bills contain a civil penalty for participating in the fraud of another. For the reasons indicated, we support the provisions of H.R. 6300.

Penalty for Frivolous Return

The IRS has recently encountered the small but troublesome compliance problem of "protest" tax returns. These returns are either based on wholly groundless theories -- such as that no tax is due because the United States is no longer on the gold standard -- or consist simply of zeros filled in on all blanks on the return or the like. At present, the Service's sole method of dealing with these "returns" is to refuse to treat the filed document as a tax return. While such an approach generally has been upheld by the courts, often no penalty may be imposed on the taxpayer because withholding tax or estimated tax payments will eliminate any deficiency.

H.R. 6300 would impose a penalty of $500 for filing an income tax return that either does not contain information on which the substantial correctness of the self-assessed tax may be judged, or contains information that on its face indicates that the self-assessment is substantially incorrect, where the filing is due to a position that is frivolous or a desire to impede the adminsitration of the tax laws. The penalty would be assessed and collected independently of the underlying tax liability. The burden of proof in any action in which assessment of the penalty is challenged would be on the Secretary. H.R. 5829 contains no parallel provision.

As we read this provision it would have no application whatever to a taxpayer who attempts to urge a position that has some basis in the law. Instead, the penalty is directed at returns which, on their face, are wholly improper. Therefore, we believe the scope of this penalty is appropriately circumscribed, and we support this provision.

A related practice by certain tax "protesters" that has come to our attention is the commencement of lawsuits against employers who transmit copies of employees' wage withholding statements (Form W-4) to the IRS when required to do so by Treasury regulations. Such forms are required to be forwarded to IRS, for example, if the employee claims to be wholly exempt from wage withholding. It is clearly undesirable for employers to have to defend such actions in court. Accordingly, we would request that the Committee consider adding a provision that would bar actions of this type against employers.

Administrative Summonses

If the IRS serves an administrative summons on a third-party recordkeeper requiring that person to produce a taxpayer's records, notice of the summons must then be given to the taxpayer. A third-party recordkeeper includes a bank or similar financial institution, a consumer reporting agency, a credit card company, a brokerage house, or an attorney or an accountant.

The taxpayer may stay compliance with the summons by notifying the third-party recordkeeper in writing not to comply with the summons. A copy of the notice must be sent to the Secretary. To enforce the summons, the IRS must then commence a proceeding in the district court, at which time the taxpayer and the third-party recordkeeper may assert any defenses they may have to the summons.

Taxpayers have in many cases stayed compliance with summonses merely for the purpose of delaying an IRS investigation. As a result, the IRS consumes substantial time and resources in commencing actions to enforce these summonses. Frequently, taxpayers who have stayed compliance with a summons do not appear in court to contest the summons.

H.R. 6300 would require a taxpayer to commence a proceeding in court by means of a motion to quash in order to stay compliance with a summons. The motion must be filed within 20 days after notice of the summons was given to the taxpayer. A copy of the pleading in the action must be sent to the third-party recordkeeper and the Secretary. The IRS may not examine any records under the summons before the close of the 23rd day after notice of the summons is given to the taxpayer.

H.R. 6300 would make certain other changes in the administrative summons area. The third-party recordkeeper would be required to proceed with assembly of the documents as soon as the summons is received in order to have them ready for production on the day on which the records are to be examined. After 23 days have elapsed following notice to the taxpayer, the Secretary would be permitted to certify to the third-party recordkeeper that no proceeding to contest the summons was commenced within the period permitted. In acting on such certification in good faith, the third-party recordkeeper would be protected from liability. H.R. 5829 has no parallel provisions.

We agree with these changes in the administrative summons area. The most important change in our view is the requirement that a taxpayer commence a proceeding to contest the summons. Under present law, such a taxpayer is required to go to court in order to defend an action brought by the IRS to enforce the summons. Changing the party who must initiate the court proceeding will deter those taxpayers who now require the IRS to go to court and do not defend in the proceeding. The bill will not change the costs for those taxpayers who seriously challenge a summons.

H.R. 6300 would also modify the rules relating to administrative summonses by allowing IRS to serve and enforce such a summons, whether in furtherance of a civil investigation or a criminal investigation, at any time prior to referral of the matter to the Justice Department for criminal prosecution. Once the matter is referred to the Department of Justice, IRS may not issue a summons or enforce an outstanding summons until such time as the Attorney General declines to prosecute, or there is a final disposition of a criminal proceeding that results from the referral. H.R. 5829 contains no parallel provision.

Under current case law, the authority of the IRS to issue an administrative summons is said to terminate at such time as the IRS abandons in an "institutional sense" the civil tax investigation of a person and decides to proceed exclusively under criminal law. Frequent challenges to summonses result from this rule, with the taxpayer arguing that summons' authority has been exceeded because the IRS has abandoned the civil tax investigation. In virtually all cases, the IRS prevails in establishing that it has not abandoned the civil tax investigation. However, IRS consumes valuable resources and encounters substantial delays in enforcing summonses as a result of this argument.

The rule proposed by H.R. 6300 would eliminate factual disputes concerning the abandonment of a civil investigation by making clear that IRS could exercise summons' authority at any time until a matter is referred to the Department of Justice. We believe this provision should eliminate needless delay and consumption of IRS resources in enforcing administrative summonses. Therefore, we support this provision.

TITLE II--IMPROVED INFORMATION REPORTING

Interest

Present law requires that persons making payments of interest aggregating $10 or more in a calendar year must file an information return with the Secretary and send a statement to the recipient. Interest is defined to include interest on corporate obligations in registered form, and, to the extent provided in regulations, interest on corporate obligations in bearer form, as well as interest paid by banks and other financial institutions, insurance companies, stockbrokers and securities dealers.

No reporting is required for interest paid on exempt governmental obligations, to foreign persons, on obligations issued by the United States, and on corporate bearer obligations.

A corporation that has outstanding an obligation in registered form with respect to which there is included in the income of any holder original issue discount of $10 or more in a calendar year must file a return with the Secretary stating the aggregate amount of original issue discount so includable; an information statement must be furnished to the holder.

An obligation is considered issued in registered form if it is registered both as to principal and interest (if payable), and it can be transferred only by surrender of the old instrument and (1) reissuance of the old instrument to the new holder, or (2) issuance of a new instrument to the new holder.

Because of the sweeping registration requirements in H.R. 6300, information reporting would be required on virtually all obligations issued to the public after 1982. However, no reporting would be required on tax-exempt obligations issued by State and local governments and their agencies and instrumentalities.

The bill also introduces two major changes in information reporting under current law. First, reporting would be required on interest payments by the United States and its agencies and instrumentalities. Second, reporting would be required for interest paid on bearer obligations of a type issued to the public except for obligations with a maturity of less than 1 year that are held by a corporation; this rule would impose reporting for (1) bearer obligations outstanding at December 31, 1981, and (2) short term bearer obligations held by individuals.

The Secretary could prescribe regulations under which interest and original issue discount on bearer obligations and United States savings bonds could be reported on a transactional rather than on an annual basis. However, reporting agents would be required to send statements to payees in January of the next calendar year, rather than at the time the instrument is presented for payment or redemption.

H.R. 5829 similarly would impose a comprehensive reporting system on payments of interest and the accrual of original issue discount on corporate bearer obligations and obligations of the United States, its agencies and instrumentalities. H.R. 5829 permits the structure of the reporting obligations to be prescribed by regulations issued by the Secretary.

We applaud the effort in both bills to fill the gaps that now exist in information reporting with respect to interest income, and we expect that a comprehensive system of reporting should increase compliance in reporting this income. We are concerned that implementation of such a broad system of reporting could have unexpected effects, and we would like to explore this further with this Committee.

We disagree, however, with the requirement that an institution which reports payments on bearer obligations and United States savings bonds on a transactional basis must send its statement to the payee during January of the year after the payments are made, and thus may not furnish the payee with a statement earlier. Although we recognize that information statements are most effective for increasing compliance when payees receive them at the start of the filing season for income tax returns, bearer obligations and savings bonds are frequently cashed on an itinerant basis at institutions with which the payee has no further contact. An institution that makes payments with respect to these instruments will be required to "inventory" the information to be reported for transmittal in January of the next year, rather than delivering the statement to the taxpayer at the time the interest is paid. We believe these storage costs outweigh the advantages of January mailings, and they become critical in the case of savings bonds because of the volume of transactions.

Returns of Brokers

Present law gives the Secretary regulatory authority to require persons doing business as brokers to report the names of customers and details concerning their profits and losses. This regulatory authority has not been exercised.

Both bills leave broker reporting within the Secretary's regulatory authority. H.R. 6300 would expand information reporting by brokers (other than in their capacity as nominees) in two principal ways. First, the bill would require the broker to send a statement to the customer setting forth the broker's name and address and the information reported to the IRS. Second, the bill would clarify existing law to define the term "broker" to include dealers and other persons who regularly act as middlemen with respect to property transactions, as well as barter exchanges. We understand that the drafters of the change anticipate that the Secretary will prescribe regulations at least as to securities and commodities brokers as soon as possible. The bill would require reporting of gross sale proceeds and also would allow reporting concerning other details regarding profits and losses where appropriate.

H.R. 5829 would mandate issuance of regulations requiring reporting by securities and commodities brokers on capital transactions, as well as the sale or transfer before maturity of any bond or other evidence of indebtedness (other than corporate transfers of Treasury bills and certain short-term obligations).

The extremely poor rate of compliance for capital transactions makes information reporting by brokers desirable. We are concerned about the costs that this reporting will place on the industry, however, and the relationship between those costs and the value to the IRS of this information reporting. Our preliminary information is that reporting that is limited to gross sale proceeds, without details as to profits and losses, will be useful to the IRS and not overly costly to the industry to produce.

We testified before the IRS Oversight Subcommittee of the Senate Finance Committee concerning S. 2198 that requiring brokers to provide an annual statement to customers recapitulating the information provided to the Secretary would be extremely helpful to taxpayers. Therefore, we favor the provision in H.R. 6300 that requires information reports to be furnished to customers in those cases in which reports are required to be sent to the IRS.

The barter exchange provisions of H.R. 6300 merit brief discussion. The Treasury has long been concerned about compliance problems that are presented by barter exchange transactions. We believe that reporting requirements that would provide the IRS with information about barter transactions will be of enormous value to the IRS. The bill also treats barter exchanges as third-party recordkeepers for purposes of the administrative summons provisions. Although this is not a provision that we would have requested, we do not oppose the provision if the streamlining of the administrative summons procedure by means of the motion to quash proceeding and information reporting requirements for barter exchanges added by H.R. 6300 are enacted as well.

Information Reports to Nonemployees

H.R. 6300 would require, as under current law, that persons engaged in a trade or business file information returns on payments of $600 or more during the calendar year to any person for services. The bill would expand information reporting by the direct sales industry. Anyone in the trade or business of selling products to any buyer on a direct sale basis for resale in a home or other than in a permanent retail establishment would be required to file an information return on sales of $600 or more during the calendar year. This provision would extend to both direct and so-called multi-tiered organizations. H.R. 5829 has no parallel provisions.

Noncompliance among independent contractors is a significant problem of the tax gap. We believe that improved compliance measures should be taken in this area, both with respect to expanded information reporting and increased penalties for failure to comply.

The bill does not change the current law threshold of $600 for information reporting. It would be appropriate to consider lowering this figure substantially with respect to payments for services. In the area of interest and dividends, the reporting threshold is currently $10, and wages are reported from the first dollar earned. Compliance would improve if taxpayers knew that their payments had been reported to the Internal Revenue Service.

We welcome the recognition in H.R. 6300 that information reporting by direct sellers should be expanded. The IRS has been reviewing what information from the direct selling industry it could best use to determine accurate tax liabilities in this area. After close examination, and taking into account the difficulties in comparing gross sales with amounts reported by taxpayers on their returns, the Service has concluded that they will better be able to use mandatory information reporting on commissions, bonuses, prizes, etc., in excess of $100 in the calendar year. At the same time, reporting of the name, address, and taxpayer identification number should be required for those direct sellers with purchases in excess of $100 annually. This would provide the IRS with some means to obtain information on those sellers who are compensated only by the difference in the price at which they purchase goods and then resell them.

State and Local Income Tax Refunds

Taxpayers are required to include in income the amount of any State or local income tax refund, if the tax was deducted in a prior year and the deduction gave rise to a tax benefit. Frequently, however, taxpayers fail to include these refunds in income. Doubtless this noncompliance sometimes results from taxpayers' ignorance of the requirements of substantive law. In addition, we believe that taxpayers often completely overlook the fact that they received a refund in the prior year or lack the particulars about the refund when they fill out their income tax returns. These bills would go far to remedy both of these problems.

H.R. 6300 would provide that State and local taxing entities would be required to report to IRS refunds, credits or offsets against tax of an individual aggregating $10 or more during a calendar year. A statement would also be required to be furnished to the taxpayer during January of the year following payment of the refund, or the crediting or offset.

H.R. 5829 contains a substantially similar provision, except that its application is not limited to credits, refunds and offsets of individuals.

These provisions are clearly desirable from the point of view of Federal tax administration. We must, however, tread carefully in imposing a requirement of even this limited nature on State and local governments. We note that there has been a profileration of information exchange agreements between the Federal and State governments. It is anticipated that many States would satisfy their obligations under this provision by simply providing the information under current agreements (although information would also be required to be provided to taxpayers, a practice that is not now in effect).

It thus appears that it would not be unduly burdensome to ask the States and local governments to take the further step of insuring that taxpayers have the needed records concerning State tax refunds to complete their Federal tax returns.

Our preference would be to limit the application of this rule to payments to individuals, in part because other taxpayers (corporations, trusts, estates) will frequently have professional return preparers who would have less need for information reports of this type.

Casualty Reimbursements

An individual may deduct losses in excess of $100 arising from fire, storm, shipwreck, or other casualty, or from theft if the losses are not compensated for by insurance or otherwise. The IRS finds many situations in which individuals who receive reimbursement for a loss under a casualty insurance policy also claim a casualty loss deduction.

H.R. 6300 would require a person making payments of casualty or theft insurance proceeds of at least $600 in a year to file a return with the Secretary and to send a statement concerning the payment to the taxpayer. H.R. 5829 contains no parallel provisions.

Information reporting such as this is valuable to the IRS in auditing returns and in insuring that taxpayers treat casualty loss items properly in filling out their tax returns. However, we have some concern regarding the expense to the industry of instituting a reporting system of this nature. We would like the opportunity to work with this Committee to determine the relative costs and benefits of instituting this reporting.

Charged Tips

Employees who receive tips of $20 or more in a month are required under present law to report such tips to their employer. The employer, in turn, is required to report these tips to the IRS (and to the employee). The employer is similarly obligated to withhold tax on tips reported by the employee.

Tips are clearly compensation and thus constitute taxable income. Current estimates show that employees report less than 20 percent of their tip income. This is simply unsatisfactory taxpayer compliance. H.R. 5829 would require employers to treat tips that are charged on a credit card, and paid over by the employer to an employee, as wages subject to information reporting. Small employers, who are defined as those who normally had five or fewer employees during the preceding calendar year, would be exempt from this reporting requirement. H.R. 6300 contains no parallel provisions.

Since a paper record is already generated by the credit card transaction in which the tip is paid, there should be little additional paperwork burden as a result of this requirement; it is therefore desirable to impose information reporting in these circumstances.

Increased Penalties for Failure to File Information Reports

The bills provide for a series of revisions to the penalty provisions relating to information reporting and add a withholding requirement in the situation where no social security number or other taxpayer identification number is provided to a payor or where the IRS has notified a payor that a number is incorrect. Generally, the provisions of the two bills are the same.

Briefly, these provisions are:

- Where a payor fails to file an information return on dividends, interest or other amounts, the penalty would be increased from $10 to $50 per failure, but not to exceed $50,000 (increased from $25,000). If the failure to file such returns is due to intentional disregard of the filing requirements, the penalty would be 10 percent of the amount of the payment (5 percent in the case of reports by brokers under H.R. 5829) without limit. H.R. 6300 would also make the penalty applicable to the filing requirement it imposes for direct sellers.

- Where a person fails (1) to furnish a taxpayer identification number to a payor, (2) to include a taxpayer identification number in a return, or (3) to include the taxpayer identification number of another person in a statement or return filed (e.g., A's failure to include B's social security number on a Form 1099 issued to B), the $5 penalty provided under present law would be increased to $50, for all such failures during a calendar year, except that H.R. 6300 would limit the penalty for a failure under (1) to $10. H.R. 5829 would impose a maximum annual aggregate penalty of $50,000, but where the failure to include another person's taxpayer identification number in a return filed is intentional, it would provide a penalty of $100 per failure, with no limit.

- If a payee fails to provide a taxpayer identification number to a payor, withholding would be required at a rate of 10 percent under H.R. 6300 and 15 percent under H.R. 5829. Alternatively, if IRS determines that the taxpayer identification number provided to the payor is incorrect, the payor would start withholding upon notice from the IRS that the taxpayer has failed to supply the correct taxpayer identification number. Withholding would continue as long as the taxpayer fails to provide a number or does not correct an incorrect number. H.R. 6300 would extend both penalty withholding provisions to direct sellers.

Persons should not be able to disregard or deliberately avoid information reporting responsibilities with the expectation that a failure to report income will provoke, at most, trivial sanctions. These bills go far in making the various Code reporting requirements meaningful by generally increasing the penalties for refusals to comply. I would like to comment on two of these penalty provisions.

The minimum penalty of 10 percent of the amount subject to the reporting requirement (5 percent in the case of reports by brokers under H.R. 5829) where a payor intentionally disregards the filing requirements would in some cases result in a substantial penalty. However, we think significant penalties are appropriate where parties knowingly attempt to subvert the reporting requirements that are crucial to the functioning of our tax system.

Next, let me mention the "penalty withholding" provision. Many information reports which are received either lack a taxpayer identification number altogether or show an incorrect number. Fully 11 percent of the reports on dividends and interest payments lack this information. These defective reports are in many cases worthless to the IRS; those reports that are corrected are done at very substantial expense. By implementing a system of source withholding on persons who are not willing to provide correct taxpayer identification numbers, this provision will place the onus of correct information reporting on the person best able to insure that the reporting is accurate. We think this is an appropriate and desirable sanction.

However, we foresee difficulties with implementing penalty withholding on certain direct sales. H.R. 6300 would treat the seller of products on a direct-sale basis as having made a "payment" to the buyer (who in turn will resell the products either in the home or to another direct seller). The "payment" would equal the amount of the sale. Where penalty withholding applies, the seller would be required to "deduct and withhold" a tax of 10 percent of the payment.

Where a purchaser of goods in the chain of distribution receives cash payments for commissions, bonuses, prizes, etc., along with the right to retain the difference between the price at which the goods are purchased and the price at which he resells them, penalty withholding is feasible because a payor can withhold the amount attributed to the sales from the other cash payments. However, where the sole remuneration is the "markup" on the products themselves, no cash payment goes from the payor to the purchaser of the products. The payor thus could pay the tax and be unable to collect it subsequently from the buyer, even though presumably the buyer would be entitled to credit for the amount paid over to the IRS. We would be happy to work with this Committee to refine this provision, given the desirability of ensuring correct taxpayer identification numbers.

We note that the level of the penalty for failure to furnish payees with information statements, which tracks the penalty for failure to file reports with the IRS under current law, has been left unchanged in H.R. 6300. This is a technical oversight in our view and the bill should increase this penalty as well.

Minimum Penalty for Extended Failure to File

Under present law, a person who fails to file a tax return on a timely basis is subject to penalties based on a percentage of the amount of tax due. Thus, where no tax is due, no civil penalty can be assessed. In many cases, IRS finds it necessary to seek out persons who have failed to file their tax returns in order to obtain such persons' returns. Many of these persons ultimately are entitled to refunds. In those cases, the Service's efforts to compel the filing are not recompensed, except for the value of the right to use the refund without interest expense (assuming that the IRS pays the refund within 45 days after the return is filed). H.R. 5829 addresses this problem by imposing a minimum late filing penalty of $100 when a return is filed more than 60 days after the return due date (including extensions). H.R. 6300 contains no parallel provision.

We have two reservations about this provision. Initially, we are concerned about the effect of codifying a rule allowing late filing by 60 days. Although we recognize that there could be substantial practical problems in applying this penalty without a grace period, we are not persuaded that Code-sanctioned late filing is a desirable rule of law.

Second, we are concerned that application of the penalty could give rise to a perception of government insensitivity in certain cases where a penalty was applied to poorly informed persons; however, a liberal construction by IRS of the "reasonable cause" exception to the penalty would go far toward allaying those concerns.

Relief From Criminal Penalty for Failure to File Estimated Tax Return Where Exceptions Applicable

Under present law, the obligation to file an estimated tax return, and the criminal sanction for failure to file such a return, are not correlated with the exceptions to the penalty for underpayment of estimated tax liability. Thus, a sanction for failure to file an estimated tax return may exist for a person who would incur no penalty for underpayment of estimated taxes because one of the statutory exceptions is applicable. H.R. 5829 would conform the rules imposing criminal liability for failure to file a return to the exceptions from liability for underpayment of estimated taxes. H.R. 6300 contains no parallel provision. We support the correction contemplated by H.R. 5829.

Reporting in Machine-Processable Form

The bills would permit the Secretary to require that tax returns be filed in a machine-processable form or on magnetic media. It is substantially simpler and cheaper for the IRS to process documents that are filed in machine-processable form. Many persons filing large numbers of returns now voluntarily report in magnetic form. Reporting on magnetic media is typically no more expensive (and often less expensive) than reporting on paper. At a time when businesses are increasingly relying on computers to perform basic information processing functions, it seems appropriate to confirm that the Commissioner may require reporting in this manner, recognizing that it will be necessary to employ a flexible approach to take into account situations where persons do not have computer capability.

Paperwork Reduction

Both bills eliminate oversight by the Office of Management and Budget over certain Treasury functions, particularly those discharged by IRS, under the Paperwork Reduction Act of 1980.

The Administration has carefully considered this provision of these bills. The Administration is committed to the reduction of paperwork burdens where possible, including those that may be imposed by the IRS and Treasury. Therefore, the Administration believes OMB oversight over Treasury under the Paperwork Reduction Act is appropriate, and opposes this provision.

TITLE III--PENSIONS AND OTHER RETIREMENT INCOME

Withholding on Retirement Plan and Annuity Distributions

H.R. 6300 and H.R. 5829 both would impose reporting requirements on employers who maintain deferred compensation plans, on administrators of such plans, and on issuers of annuity contracts; and would subject all payments from qualified retirement plans, individual retirement accounts and commercial annuities to withholding unless the recipient elected not to have withholding apply. The major differences between H.R. 5829 and H.R. 6300 relate to recordkeeping requirements and the withholding requirements imposed on lump sum distributions. We believe that both bills contain provisions that will help to close the compliance gap.

Current Law

The basic principle that underlies the taxation of distributions from qualified retirement plans or commercial annuities is a familiar one: distributions that exceed the recipient's basis are generally includible in income in the year received. However, the rules for determining the recipient's basis are often complex, and significant exceptions to the general rule exist. As a result, taxpayers often do not understand the extent to which distributions constitute taxable income. The problem is compounded by the current withholding system and exacerbated by inadequate reporting requirements.

Under current law, there is no withholding on total or lump sum distributions. The recipients of such distributions must either increase wage withholding or make estimated tax payments. Many retirees have no wages and are unfamiliar with the estimated tax system. Without withholding they may unintentionally incur a penalty for underpayment of estimated tax. In the case of periodic pension or annuity payments, withholding is possible under current law, but only if it is requested by the recipient.[1] Thus the current withholding system is partial, voluntary, and requires an affirmative act by the recipient.

In addition, the present information reporting system is not effective in providing taxpayers and the IRS with the information needed to determine tax liability.

---

[1] There are limited cases in which withholding is mandatory, *e.g.*, military retainer pay and military retirement pay.

Reporting

The pension and annuity reporting requirements contained in H.R. 6300 and H.R. 5829 are identical in most respects. These requirements would constitute important steps in closing the compliance gap.

Under current law, a person who makes pension or annuity payments subject to voluntary withholding must report such payments to the IRS and to the recipients of the income. If payments are not subject to voluntary withholding, reports are required only if payments in a taxable year aggregate $600 or more. Lump sum distributions from pension plans and commercial annuities are reported on Form 1099R, while Form W-2P is used for periodic payments. These forms are designed to provide taxpayers and the IRS with the information needed to calculate the individual's income tax liability. However, in many cases, the party making the payment has no access to the information required to complete the report. For example, in order to compute the capital gains portion of the recipient's distribution, it is necessary to know when the recipient's plan participation began and when it ended. In most cases that information is in the possession of the plan administrator, rather than the bank trustee or insurance company that makes the payments and files the required reports. While employers and plan administrators generally provide recipients with the required information, there is no statutory obligation that they do so.

Under both bills, plan administrators and employers would be required to provide both the recipients of distributions and the IRS with the information needed to determine income tax liability. In addition, the Secretary would have the authority to require plan administrators and employers to provide this information to payors of retirement benefits. For example, an employer whose plan is funded through insurance contracts would be required to provide the insurance company with the information necessary to complete reports to plan participants and to the IRS. Under H.R. 6300, reporting requirements would also be imposed on issuers of insurance or annuity contracts.

We believe it is imperative that an obligation to furnish information be imposed on plan administrators, employers, and issuers of insurance or annuity contracts. We therefore support the reporting requirements of H.R. 6300.

Recordkeeping

The most significant difference between the pension withholding provisions of H.R. 6300 and H.R. 5829 is the recordkeeping requirement imposed by H.R. 6300. The bill would require any person who has, or may have, a duty to file reports on pension plan distributions to maintain a data base containing the data required by such reports. The content of the data base would be prescribed by regulations. A person who failed to maintain the data base would be subject to a penalty tax for each calendar year in which a failure to keep the required records occurred. The penalty would be $50 for each individual participant or beneficiary with respect to whom the failure occurred, with a maximum annual penalty of $50,000. The penalty would not be imposed if failure to keep records were due to reasonable cause, inability to correct a previously penalized failure to keep records, or inability to correct a failure to keep records prior to January 1, 1983.

The recordkeeping provision of H.R. 6300 is designed to ensure that adequate reports on pension and annuity distributions can be supplied. We would like to stress that incentives to maintain records exist under current law because a payor who fails to file a return required under section 6047 of the Code is subject to a penalty of $10 for each day during which the failure to file continues. The maximum penalty is $5,000 for each return. Therefore, an individual who fails to maintain adequate records will be penalized for this failure when an incomplete return is filed.

The proposed recordkeeping requirement in H.R. 6300 would provide the Service with an additional method to detect and penalize inadequate recordkeeping by plans that make distributions infrequently, e.g., once every ten years. However, such plans cover few of the many participants in qualified plans. We question whether it is appropriate to impose a substantial regulatory burden on all plans because of these atypical plans.

Withholding on Annuity Payments

H.R. 6300 and H.R. 5829 apply slightly different withholding rules to annuity payments.

Under H.R. 6300, the taxable portion of annuity payments, which is the amount attributable to employer contributions, would be subject to withholding as if it were wages. Withholding would generally begin in the third month after payment commenced. The recipient, however, could elect not to have withholding apply, and the election would remain in effect until revoked. However, payors would be required to notify recipients annually of the opportunity to have withholding apply to their annuity payments.

H.R. 5829 would treat all periodic payments and all other payments that are not qualified total distributions as wages subject to withholding. Payors would be required to notify recipients of the opportunity to elect out of the withholding system. However, withholding would commence with the first payment if no election were timely received, and the election would require annual renewal.

We support the measures contained in both bills to make it easier for pension recipients to use withholding and to avoid the obligation to make estimated tax payments. However, we believe that the annual election provision of H.R. 5829 will impose undue burdens on retirees and on plan administrators. Allowing an election to remain in effect until revoked is far less burdensome to both retirees and plan administrators.

We are also concerned that delaying withholding until the third month after payments commence, as permitted by H.R. 6300, will cause retirees to incur unanticipated estimated tax penalties. We suggest that, except as otherwise provided by regulations, notice of the right to elect not to have withholding apply be required to be provided no more than 90 and no less than 30 days before payments commence. Such a notice requirement would provide retirees with a reasonable opportunity to determine their withholding needs. We understand that such a notice provision could be incorporated into the benefit claims procedures used by most qualified plans. Administrative exceptions to the advance notice requirement could be provided in appropriate cases, such as the withdrawal of funds from an individual retirement account or a sudden decision to retire. In addition, we suggest that a similar notice provision be required in the case of nonannuity distributions from qualified plans, IRAs, and commercial annuities.

Withholding on Nonperiodic Payments

H.R. 6300, unlike H.R. 5829, contains separate rules for withholding on nonperiodic payments, *i.e.*, payments that are neither qualified total distributions nor periodic payments. Withholding on such distributions would differ from withholding on annuity payments in that withholding on nonperiodic payments would be imposed at a flat rate of 10 percent, rather than in accordance with wage withholding tables. This is a significant simplification. It is attractive because the use of current wage withholding tables would impose higher withholding on payments made earlier in a year. Flat rate withholding may, however, conflict with the objectives of enabling retirees to use the withholding rather than the estimated tax system if they desire. We therefore believe it is preferable to apply wage withholding to such payments. In many cases, recipients can avoid overwithholding by claiming additional allowances or by electing not to have withholding apply. However, in other cases the existing wage withholding system may not provide sufficient flexibility to meet retirees' needs. We therefore suggest that the statute provide the Secretary with the authority to develop appropriate rules for withholding on amounts that are not paid in annuity form.

In addition, we believe that it may be difficult for payors of distributions to determine whether a payment is a periodic payment subject to wage withholding or a nonperiodic payment subject to flat rate withholding. We believe that treating both types of distributions in the same manner would avoid unnecessary complexity.

Withholding on Qualified Total Distributions

H.R. 6300 and H.R. 5829 differ in their withholding rules on the taxable portion of a total distribution. Under H.R. 6300 a qualified total distribution is a distribution to the recipient of the balance to his credit under a qualified plan or section 403(a) annuity which it is reasonable to believe will be made within one taxable year of the recipient. Only the taxable portion of the distribution would be subject to withholding, and the recipient may elect not to have withholding apply. Withholding would be calculated on the basis of the ten-year averaging rules and capital gains rules of section 402(e) of the Code.

H.R. 5829 would also impose withholding on the taxable portion of a "total distribution," but with four main differences. First, the requirement that it be "reasonable to believe" that the distribution will be made within one taxable year is absent. The "reasonable to believe" concept of H.R. 6300 will simplify administration of the withholding system as it will eliminate the need for a plan administrator to ascertain the recipient's taxable year. Second, under H.R. 5829 the recipient can elect not to have withholding if he notifies the payor that the distribution will be rolled over to an individual retirement account (IRA) or a qualified plan. This places the individual who wishes to use the estimated tax system in an undesirable position: he must state that he will roll over the distribution in order not to be subject to withholding. Withholding in this case is not truly voluntary.

Third, under H.R. 5829 withholding would be calculated on the basis of the ten-year averaging rules of section 402(e) of the Code but without regard to the capital gains rules. This omission may result in occasional overwithholding. H.R. 6300 avoids the overwithholding that might occur under H.R. 5829 by considering the capital gains portion of the distribution but withholding agents must make three calculations under H.R. 6300 to determine the appropriate rate of withholding. In order to simplify the burden of administration, we suggest that the capital gains rule not be applied. Instead, we suggest that the Secretary be given authority to prescribe regulations under which retirees could elect a smaller amount of withholding than would apply using ten-year forward averaging without electing out of the withholding system entirely.

Finally, H.R. 5829 imposes withholding on total distributions from IRAs and commercial annuities at ten-year averaging rates rather than at wage withholding rates. We believe it is preferable to subject these payments to wage withholding, for they will never be eligible for ten year forward averaging.

H.R. 6300 and H.R. 5829 also differ in their treatment of rollovers. If tax is withheld from a distribution that could be rolled over to an IRA or a qualified plan, H.R. 5829 allows deferred rollover of an amount equal to the tax withheld. This permits the use of tax refunds to complete the desired rollover. H.R. 6300 does not permit a deferred rollover, thereby simplifying the withholding and rollover rules. However, since recipients need not receive advance notice of the ability to elect not to have withholding apply under H.R. 6300, some participants who wish to roll over their entire distribution will not be able to do so. Rather than the approach of either bill, we favor requiring that recipients receive advance notice of the ability to elect out of withholding.

A final difference between the two bills relates to the tax treatment of death benefits excluded from income under section 101(b). H.R. 5829 provides that any potential death benefit is not subject to withholding whether or not it is includible in income. Under H.R. 6300 the payor must determine whether it is reasonable to believe that any portion of the death benefit is not includible in gross income. We believe that a workable standard of "reasonableness" will be difficult to develop and administer and therefore suggest that the maximum $5,000 death benefit under section 101(b) be excluded from the taxable portion of any distribution made by reason of a plan participant's death.

Although we have certain technical reservations concerning both H.R. 6300 and H.R. 5829, we embrace the concept behind both bills that withholding allows taxpayers to meet their tax obligations more easily and, therefore, that withholding should be extended in the retirement income area. However, the Committee may want to consider whether a mandatory withholding system may be easier for taxpayers to understand and for plan sponsors to adminster.

Effective Dates of Pension Withholding Provisions

The pension withholding provisions of both H.R. 6300 and H.R. 5829 would generally be effective for post-1982 payments. We are seriously concerned that these effective dates provide insufficient time for implementation of a new pension withholding system. It will take the Department of the Treasury and the IRS several months to develop the computational procedures and regulations contemplated by the bill and to revise reporting forms. Payors will then require several months to set up new administrative procedures to implement withholding. After that, notice of the opportunity to elect out of withholding must be provided to participants. We recognize that an early effective date appears most efficacious in closing the compliance gap, but we suggest that such an appearance is deceptive. Specifically, we are concerned that an unrealistic effective date will lead payors to encourage recipients to elect out of the withholding system altogether. A later effective date may therefore be a more productive means of closing the compliance gap.

Early Withdrawal Penalties

Under current law, the penalty imposed on early withdrawals from individual retirement arrangements (IRA's) is 10 percent of the amount includible in gross income. The same penalty applies to early withdrawals of deductible employee contributions and to premature distributions to owner-employees. H.R. 6300 would increase this penalty to 15 percent. This increase is designed to increase the effectiveness of the penalty in discouraging premature withdrawals and therefore to make available more funds for retirement income. H.R. 5829 has no parallel provision.

We are concerned that the increase in the penalty will not have its intended effect of reducing premature withdrawals. Those persons who must make premature withdrawals due to hardship will obviously not be deterred by the penalty and will face the additional burden of the increase. Those persons who use IRA's or qualified plans as a tax-sheltered savings account may alter their behavior but will still ultimately make premature withdrawals. The increased penalty will simply require that they retain their tax-sheltered account for a slightly longer period. For example, under current law a person in the 19 percent tax bracket who invests $2,000 per year in an IRA yielding 12 percent overcomes the adverse effects of the 10 percent penalty tax after 10 years of IRA participation. The breakeven point occurs earlier if the individual is in a higher tax bracket, if the IRA yields more than 12 percent, or if the individual's tax bracket declines between the time the IRA contribution is made and the time it is withdrawn. With a 15 percent penalty tax, the breakeven point will occur after 16 years of IRA participation. In the case of a taxpayer in the 50 percent tax bracket, the breakeven point would increase from approximately 7 to approximately 11 years. Thus the increase in withdrawal penalties does not ensure that funds will be available for retirement.

Second, we are concerned that an increased withdrawal penalty will deter the use of IRA's and deductible employee contributions by low and middle income individuals. We need to make special efforts to encourage use of IRA's and DEC's by these groups. We must therefore recognize that low and middle income individuals typically have limited cash resources available when they face hardship or financial emergencies. Their IRA's or DEC's may constitute their most significant cash resource. If withdrawals are subject to increased penalties, such individuals will be less likely to use IRA's or DEC's.

In summary, we are concerned that the proposed increase in the early withdrawal penalty will decrease retirement savings by low and middle income individuals and fail to prevent use of IRA's as tax-sheltered savings accounts. We oppose this provision of H.R. 6300.

Partial Rollovers of Individual Retirement Accounts

H.R. 6300 would permit partial rollovers of distributions from individual retirement plans. H.R. 5829 has no parallel provision.

Under current law, partial rollovers of lump sum distributions from qualified plans, from section 403(b) annuities, and from deductible employee contribution accounts are permitted. Partial rollovers of individual retirement account distributions should also be permitted. We support this provision of H.R. 6300.

TITLE IV--TRANSACTIONS OUTSIDE THE UNITED STATES

The provisions of H.R. 5829 are restricted to dealing with taxpayer compliance issues in the domestic sector. However, compliance problems are serious in the foreign sector as well. These problems have derived primarily from the inability of the IRS in many instances to obtain adequate or timely documentation of foreign transactions engaged in by U.S. taxpayers and from the complexity inherent in the present information reporting system for such transactions.

Title IV of H.R. 6300 is intended to bolster, and in many instances to simplify, the present enforcement and reporting provisions related to the activities of U.S. taxpayers outside the United States. Except as noted below, we support the provisions of this title and consider such provisions to reflect a laudable effort to improve a compliance system that at this time is not entirely effective.

Title IV may be divided into two major categories of provisions--those relating to access by the IRS to taxpayers' books and records which are maintained outside the United States and those relating to the various information returns required in connection with certain foreign entities and transactions. I would like now to describe and comment individually on the more significant of these provisions.

Access to Books and Records

In the foreign area, as well as the domestic, a taxpayer presently has the burden of proving the tax effects of the transactions in which he participates and has the responsibility of maintaining such books and records as prescribed by the Secretary of the Treasury. Nevertheless, the IRS encounters frequent difficulty in obtaining sufficient documentation to deal effectively with the foreign transactions of persons who are subject to U.S. tax. This difficulty may arise in situations involving anything from attempts to launder illicit drug proceeds through tax-haven bank accounts to the use of delaying tactics to force a more favorable settlement with the IRS.

H.R. 6300 would provide two different means of dealing with these problems -- first, by enhancing the enforceability of summonses served on persons outside the United States and second, by limiting the ability of a noncompliant taxpayer to prove his tax position in court.

Jurisdiction of Courts and Enforcement of Summons

One means by which the IRS can obtain adequate information with respect to transactions in a purely domestic context is to serve a summons on the person who is in possession of the documents containing such information and to seek to have such person held in contempt of court if he does not respond appropriately. However, this procedure can be less than effective where the documents being sought are maintained outside the United States.

Although current law permits an administrative summons to be served on a U.S. person outside the United States, it confers jurisdiction to enforce such a summons only on the U.S. district court for the district in which the person "resides or is found." Because the person served outside the United States oftentimes neither resides in nor can be found in the United States, such a summons is often unenforceable.

To eliminate this unwarranted incongruity in the current law, H.R. 6300 would establish venue in the district court of the District of Columbia for the enforcement of summonses related to tax matters where the person served neither resides in nor is found in the United States. We believe that this provision would effectively remedy a situation whereby foreign-based taxpayers are permitted blatantly to disregard the legitimate demands of the IRS for tax-related documentation.

Inadequate Books and Records--Inadmissibility of Evidence and Presumptions

As a complement to the venue provision which I have just described, H.R. 6300 contains a provision which would restrict the ability of a taxpayer to prove his position in court if he refuses to provide the IRS with foreign-based books and records. This provision is directed to those cases which occur most particularly where taxpayers who maintain their books and records outside the United States cite foreign law as an obstacle to producing the books and records upon request by the IRS. It is not uncommon for these books and records to be "magically" produced by the taxpayer "at the court house steps," a point in time at which it is too late for their adequate review by the Service. We believe that this provision, which I will now describe in more detail, would be effective to curtail use of this abusive tactic in most cases.

Specifically, H.R. 6300 provides that if a taxpayer fails to comply in a timely fashion with a request by the IRS for tax-related documents located outside the United States, the documents covered by the request may not later be introduced by the taxpayer in court to prove his view of the tax effects of his transactions.

A taxpayer generally would be given 90 days to comply with such a document request. However, the Secretary would be empowered to extend the time limit in appropriate circumstances (which might include, for instance, cases in which the administrative "red tape" of a jurisdiction in which documents are kept prevents their timely release).

An exception is provided for cases in which a taxpayer can demonstrate to the court that there was reasonable cause for his failure to comply with a document request. However, the bill expressly provides that reasonable cause for such failure does not include the fact that a foreign jurisdiction imposes criminal or civil penalties on the taxpayer or on any other person for disclosing the requested documentation. This latter provision would prevent taxpayers from citing bank secrecy and similar laws of tax-haven jurisdictions as a basis for not producing documents when requested by the IRS and then later producing such documents in court.

In addition to restricting the admissibility of evidence when a taxpayer has failed to comply with a document request, H.R. 6300 would provide a presumption that deductions or credits purported to arise from a foreign transaction to which the document request is related are not allowable. Similarly, it would provide a presumption that any amount received with respect to such a transaction is income if a document request related to the transaction is not complied with.

In our view, these presumptions regarding income, credits and deductions arising in connection with foreign transactions would codify current law. So long as it is clearly reflected that the intent of the Congress in enacting these provisions is to codify current law, we would not oppose these provisions.

Finally, H.R. 6300 provides that if a non-U.S. person fails to comply with a document request related to its U.S. trade or business, the Secretary may require that books and records for such trade or business thereafter be maintained in the United States. Although we support this provision, we note that no specific penalty is provided for a case in which a taxpayer refuses to maintain its books and records in the United States after so required by the Secretary. We suggest consideration of a sanction that would parallel the inadmissibility of evidence and the presumption provisions just discussed. That is, if a taxpayer refused, upon direction by the Secretary, to maintain his books and records with respect to a particular trade or business in the United States, those books and records could not be used as evidence in court for the taxpayer's position on tax matters, and the income and tax benefit presumptions would apply with respect to all items related to that trade or business.

Information Returns

The second set of foreign-related provisions under Title IV--those concerned with information returns for foreign entities and transactions--are focused primarily on the simplification of certain penalties and certain information reporting requirements which are applicable with respect to foreign-related transactions. As a number of the provisions under current law are overlapping and unduly complicated in certain respects, they in and of themselves may be a source of taxpayer noncompliance. Therefore, we support the following amendments contained in H.R. 6300, which would clarify and coordinate these provisions.

Penalty Provisions

H.R. 6300 would modify the penalty which applies in a case in which a U.S. person who controls a foreign corporation fails to furnish certain tax-related shareholder and financial information with respect to the corporation.

Under current law the penalty for failure to furnish requisite information relating to a controlled foreign corporation is a 10 percent reduction of the delinquent taxpayer's foreign tax credit. Additional 5 percent reductions may be imposed at three-month intervals during a continuation of such failure. Because this penalty is complicated to administer and, in many cases, is perceived to be unduly severe, there has been a reluctance on the part of the IRS and the courts to impose it. Consequently, the current penalty fails in many cases to be a deterrent against lack of, or inadequate, reporting.

H.R. 6300 would impose a fixed $1,000 penalty for failure to file information for each accounting period of a foreign corporation controlled by the taxpayer. Additional $1,000 penalties would be imposed for each 30-day period or fraction thereof during which the failure to file continues. The dollar penalties so imposed would reduce or offset an otherwise applicable foreign tax credit penalty. However, when considered appropriate, the IRS would be able to impose the balance, if any, of such foreign tax credit penalty in addition to the fixed dollar penalty.

Because the fixed dollar penalty is less complicated than the present penalty and, in many cases, is less likely to be unduly severe, we believe that it will be imposed more frequently in cases where a penalty is clearly appropriate. We approve continued application of the more stringent foreign tax credit penalty for particularly egregious cases of noncompliance.

H.R. 6300 also includes a technical amendment to the Internal Revenue Code that would repeal the last sentence of section 905(c). Such sentence, although ambiguous, appears to provide a penalty for failure to report a subsequent refund of foreign taxes which would effect a reduction in a taxpayer's previously claimed foreign tax credits. As a penalty for such an offense is clearly provided elsewhere in the Code, we believe that the deletion of this sentence is appropriate.

Simplification of the Reporting System

To simplify and streamline the current reporting system for foreign entities and transactions, H.R. 6300 contains provisions which would enable the IRS to collect the information it needs with respect to such entities and transactions on a single composite form. Such information is now collected on a variety of different forms, and taxpayers commonly are required to provide the same information more than once with respect to a single entity. Needless to say, this duplication of paperwork can be burdensome both for the taxpayer and for the IRS.

One of the principal reasons that foreign information is reported on a variety of forms is that disparate filing dates are provided under the Internal Revenue Code for any number of individual items of information. Whereas certain of the foreign-related information returns are required to be filed at the close of a taxable year, others are required to be filed on dates determined by reference to specified transactions which may occur at any time during the taxable year. (For instance, the Code presently provides for the monthly and annual filing of foreign personal holding company returns but requires a return to be filed to report a transfer of property to a foreign trust within 90 days of such transfer.) H.R. 6300 would conform the filing dates of such various returns to facilitate their incorporation into the proposed composite return. This provision alone could eliminate much of the confusion and complexity of the present reporting system and thereby could contribute to the increased efficiency and accuracy of such system, which is essential to the administration of the tax laws.

H.R. 6300 also would extend the information reporting obligation with respect to foreign personal holding companies to U.S. shareholders who directly or indirectly own 10 percent or more of the value of the outstanding stock of such a company. Under current law only U.S. shareholders who own 50 percent or more of the value of such stock are required to report, but any U.S. shareholder of a foreign personal holding company may be subject to tax on a portion of its undistributed income. In light of this disparity between reporting responsibilities and potential taxation, we believe that the proposed extension of the reporting requirement is an appropriate means of insuring more effective administration of the foreign personal holding company provisions. In addition, since 10 percent shareholders of controlled foreign corporations are required to file with respect to such corporations under current law, we view this provision as being a further step toward coordinating the various reporting provisions with respect to foreign entities.

TITLE V--MODIFICATION OF INTEREST PROVISIONS

Both bills provide for adjustments to the Internal Revenue Code interest computation provisions, which apply both to interest due to IRS as well as interest due to taxpayers.

Compounding of Interest

At present, interest under the Internal Revenue Code is computed on a simple rather than a compound basis. H.R. 5829 would provide for compounding at semiannual intervals. H.R. 6300 would provide for daily compounding.

Particularly in the case of an underpayment or overpayment that is outstanding for several years, the simple interest computation has the effect of greatly understating the amount of interest due. For example 15 percent simple interest for 1 year is equivalent to 14.5 percent interest compounded semiannually -- not a significant difference. However, 15 percent simple interest for 5 years is equivalent to only 11.5 percent interest compounded semiannually. For 10 years, a compounded rate of 9.4 percent is equivalent to 15 percent simple interest. Thus, for debts outstanding for longer periods, simple interest -- even at a high rate -- does not provide adequate compensation for the use of money. As a result, the absence of a compound interest rate in the Code discourages prompt settlement of disputes and prompt payment.

A compound interest computation under the Code would bring the tax interest computation into line with modern commercial practice, and would insure that both taxpayers and the Government are treated fairly when they are in a position to receive interest payments. This is a change that is long overdue. As between semiannual and daily compounding there is little economic difference; however, because the IRS can more easily administer daily compounding we support that approach.

Restrictions on Payment of Interest

In a study by the General Accounting Office, it was pointed out that taxpayers who file a late return are able to earn interest on a refund from the due date of the return if the IRS is not able to process the return within 45 days after receipt. The GAO perceived this to be a potential abuse, and we agree. H.R. 5829 would change this result by providing that interest would be paid only from the date on which a tax return is filed, if it is filed late. H.R. 6300 would not change the date from which interest is computed, but would deny interest altogether if the IRS paid the refund within 90 days after the return is filed, rather than 45 days, in the case of a late return.

Although interest is compensation for the use of money over time, the principle that interest should not generally be paid on a refund is presently established in the tax law -- no interest is due unless IRS fails to pay the required refund within 45 days of the date that the return is filed. The proposed changes would not diminish the Service's incentive to issue refunds promptly; they would merely deny a windfall benefit to taxpayers who might deliberately delay filing their return, hoping that the IRS will miss the 45-day deadline. We think, therefore, that these are desirable changes. We believe both of these provisions would meet the concern expressed by the GAO. The IRS has indicated that the 90-day rule contemplated by H.R. 6300 is more easily administered. Therefore, we favor that provision.

In the same vein, the bills provide that interest will be computed only from the date that a return is received by IRS in "processible" form. For a variety of reasons the IRS unfortunately receives a number of returns each year which it cannot process through its system. Although IRS prefers to work with taxpayers to rectify filing deficiencies, it is not equitable for the Service to be burdened with the obligation of dealing with such a return within the 45-day period. Therefore, it is appropriate to begin the 45 day period only after a return is received in a processable form.

Finally, the bills would limit interest on refunds resulting from operating loss and capital loss carrybacks as well as tax credit carrybacks. Under present law, interest on a refund resulting from such a carryback is computed commencing with the first day of the taxable year following the year in which the loss or credit giving rise to the carryback occurs. We understand that some taxpayers might take advantage of this rule, particularly in the context of the current high interest rates applicable to overpayments, by delaying filing a refund claim, thereby earning interest on the tax refund in excess of what they might earn at a bank or other financial institution. H.R. 5829 would provide that interest on an overpayment resulting from such a carryback would be computed from the date on which a claim for refund is filed, except that interest accruing prior to March 12, 1982 would not be affected. H.R. 6300 would provide that interest would be computed from the due date of the tax return (including extensions) for the loss or credit year, but would not affect interest accruing prior to and on the date of enactment.

It is important that we not let our basic concerns about high interest rates and large fluctuations in interest rates affect our analysis of the proper period during which interest is paid on tax. Although we think the tax system should not create artificial incentives to defer filing of a tax refund claim, some persons have asserted that the rule proposed by these bills would unduly restrict the payment of interest to taxpayers who are unable to file their returns, and, therefore, their refund claims, prior to the due date of the return for the loss or credit year. Therefore, we would like to work with this Committee to insure that there would not be inequitable application of this rule in some cases.

Interest Rate Adjustments

Under present law, the interest rate applicable to tax deficiencies and overpayments is adjusted each January 1 effective for the ensuing calendar year to a rate equal to 100 percent of the average prime rate in effect during September of the preceding year, rounded to the nearest full percentage. This rule was adopted as part of the Economic Recovery Tax Act of 1981. Prior to the 1981 Act, the rate was adjusted every 2 years, based on a rate equal to 90 percent of the prime interest rate.

H.R. 5829 would provide for semiannual adjustments to the interest rate, based on the adjusted prime rate charged by banks (rounded to the nearest full percent) during the 6-month period ending 3 months prior to the date of the change. H.R. 6300 contains no parallel provision.

Regardless of the formula employed to fix interest rates, during periods when there are significant interest rate fluctuations, the possibility of significant differences between the interest rate determined under the formula and a market interest rate will exist. Under many circumstances, however, the proposed interest formula will yield an interest rate that more closely approaches a market rate than the formula provided under present law. Therefore, we favor this change.

Substantial Understatement Penalty

We recognize that although most taxpayers wish to pay their fair share of taxes, a minority relies on flaws in the existing penalty structure to avoid taxes. This avoidance results, in part, from the opportunity under current rules to take highly questionable or aggressive positions on tax returns with the knowledge that even if the position taken is struck down, no penalty will be imposed on the resulting tax deficiency so long as a "reasonable basis" for the position taken exists. Because only a small percentage of returns are audited each year, these aggressive positions may never be scrutinized or questioned by the IRS (although it is true that the IRS audits a relatively high percentage of certain returns based on selection techniques indicating a high probability of a substantial audit adjustment). Thus, the combination of the audit lottery and the absence of effective penalties makes it profitable for taxpayers to reduce their tax liability through aggressive positions on their tax returns that masquerade as good faith constructions of the tax law. Revision of the tax law penalty structure to deal with this problem is thus clearly in order.

Some progress has been made in dealing with abusive taxpayer behavior of this sort. An overvaluation penalty was added by the Economic Recovery Tax Act to deter taxpayers from claiming exaggerated deductions or credits based on an overstated valuation of property. As structured, the penalty will apply if the claimed value of property is 150 percent or more of its true value; appraisal reports or opinions of experts will not, in general, prevent application of the penalty.

H.R. 6300 would impose an additional, nondeductible penalty equal to 20 percent of the interest payable on an underpayment of tax that results from a "substantial understatement." A substantial understatement is a deficiency that is the greater of either (1) 10 percent of the taxpayer's tax liability (but at least $5,000), or (2) 50 percent of his tax liability (but at least $500). IRS would have the authority to abate the penalty in whole or in part if there is a reasonable basis for the underpayment or part of the underpayment and the taxpayer acted in good faith.

H.R. 5829 would impose a penalty equal to 10 percent of an understatement of tax liability if the understatement is 10 percent of tax liability, but at least $5,000 ($10,000 for corporations other than subchapter S corporations and personal holding companies). In computing the understatement, items giving rise to a deficiency would be treated as having been reported properly and full tax paid thereon if the taxpayer adequately disclosed on the return or an attachment to the return that the reporting of the item was questionable. Thus, taxpayers who were uncertain about the resolution of an issue could continue to take "reasonable basis" positions, so long as they disclosed their position.

I applaud the sponsors of these measures for squarely facing the difficult issue of overly aggressive returns filed by taxpayers. It is important to reverse the perception among some taxpayers that adopting aggressive tax return positions is necessary or appropriate to avoid "overpaying" taxes relative to other taxpayers. A penalty for understatements of this type would undoubtedly go far in reducing that perception.

The choice between these penalties presents some difficult questions. A disclosure rule allows taxpayers to urge positions on their tax returns that are reasonable but that the IRS disputes. We are concerned, however, that adequate disclosure is difficult to define and that conscientious taxpayers would have greater costs because of fuller disclosure. Moreover, we question whether investors in tax shelters should be exempted from the penalty by disclosing issues that are obvious to the IRS while maintaining unreasonable positions on their returns.

A penalty that is not elective on the part of the taxpayer avoids these difficulties and has a greater deterrent effect because it imposes a true cost (interest not being a cost) to taking a position which produces a deficiency without fraud or negligence.

It must be recognized, however, that there are areas in which the tax law is uncertain. On balance, we prefer an approach that does not provide automatic exemption from a penalty based on disclosure because such an approach is difficult to administer. By the same token, in exercising the authority of the IRS to abate a penalty, it may well be appropriate to take disclosure into account in determining the existence of the taxpayer's good faith. Although this penalty represents a major change in the tax law, we support such a penalty in concept, and we would like to work further with the Committee in its development. In particular, we would like to be sure that the abatement procedures adequately deal with taxpayers who act in good faith.

TITLE VI--TAX TREATMENT OF PARTNERSHIP ITEMS AND SUBCHAPTER S ITEMS

Title VI of H.R. 6300 contains a proposal that would change the current procedures used in tax audits of partnerships and electing small business corporations. Although the portion of this Title applicable to partnerships was included in the bill at the request of the Administration, the Treasury Department and the Internal Revenue Service worked closely with the staff of the Joint Committee on Taxation and the staffs of the tax writing committees in drafting this proposal. In addition, the reactions of various bar associations were solicited. We believe that the partnership audit provisions of the bill would improve enforcement of the tax laws in a fair and equitable manner, and that it deserves bipartisan support. We also endorse the concept that Subchapter S corporations should be subject to an entity-level audit.

Partnership Audits

Under the proposal, a partnership will be treated as a separate entity for purposes of the auditing of partnership items, as well as for purposes of judicial review of any administrative determinations made with respect to these items. However, the rights of the individual partners are generally protected. The proposal would apply to general and limited partnerships and would be effective for audits of partnership items for taxable years beginning after enactment of the proposal.

Current Law

Under present law, partnerships are not subject to Federal income tax. Although a partnership computes the income or loss from its activities and investments, each partner is liable for any Federal income tax attributable to his share of the partnership's activities. Since a partnership is not a taxable entity, there is no administrative mechanism for making tax adjustments at the partnership level. Although the IRS may examine the books and records of the partnership, it must identify, locate, notify and obtain extensions of the statute of limitations from each partner.

At present, the IRS is not able to audit large tax shelter partnerships, which may have up to several thousand partners, in an efficient manner. One of the principal difficulties is the need to obtain and maintain the appropriate paper work for each partner. Since individual partners may reside throughout the United States, the audit of a single partnership may require the participation of dozens of IRS field offices. The resulting duplication of effort as well as the possibility of inconsistent treatment resulting from differing factual or legal conclusions reached by IRS agents or appeals officers makes it desirable to audit partnerships in a single proceeding. In addition, the true identity of the ultimate owner of the partnership interests may be difficult to determine in a timely manner where the nominal partners are other partnerships, trusts, estates or corporations.

In addition to these initial administrative problems, the absence of an effective partnership level audit creates substantial difficulties once the audit is completed. Following the initial audit determination, different partners may seek to have their liability reviewed in different forums. Some partners may take advantage of administrative review within the Service. Other partners may have their case reviewed by the Tax Court, Court of Claims, or the United States District Courts. Any determination made with respect to one partner will not preclude other partners from challenging the Service's position on the same issues. This ability to have the results of the audit considered in separate administrative and judicial forums enables the partners to "shop" individually for a sympathetic forum. It also imposes substantial administrative burdens on the IRS, which is required to commit resources and personnel to each separate proceeding.

Proposal

The proposal provides that the partnership will be treated as a separate entity for purposes of auditing partnership issues as well as for administrative settlement and judicial review. In general, a partner will be required to report partnership items consistently with the partnership's return. The IRS will make a single administrative determination of the correct amount of partnership income or loss. The individual partners, as well as the IRS, generally will be precluded from seeking further substantive administrative review of partnership related matters following the issuance of a "final partnership administrative adjustment," which would occur at the conclusion of the Service's administrative consideration of the partnership's tax return.

To ensure that all partners have a fair opportunity to participate in the administrative and judicial determination of partnership tax matters, the IRS generally would be obligated to send notice, at the commencement of any partnership level audit, to each partner whose name and address appears on the partnership's return. However, if the partnership return lists more than 100 partners, the IRS would be obligated to provide notice only to partners shown to have at least a 1 percent interest in the profits of the partnership; other partners would be entitled to receive notice from the partnership.

All partners would be allowed to participate in any administrative proceeding with respect to partnership items. The traditional administrative procedures would be available to the partnership. To make the proceedings more manageable, one partner (the "tax matters" partner) will be given certain administrative powers and responsibilities.

The IRS and any partner may enter into a settlement at any time. In the interest of fairness, the IRS would be obligated to offer consistent settlement terms to all partners. At the conclusion of the administrative proceeding, the IRS will issue a final partnership administrative adjustment, which is analogous to the notice of deficiency issued to taxpayers under current procedures.

Any partner (or group of partners) entitled to receive notice of the issuance of the final partnership administrative adjustment from the IRS would be allowed to seek judicial review of the Service's administrative determination. The action could be brought in the United States Tax Court, the Court of Claims, or the United States District Court for the district in which the partnership's principal place of business is located. However, if more than one judicial action is initiated, they will be consolidated into a single proceeding before one court. If the tax matters partner seeks judicial review, the court selected by him will have sole jurisdiction to review the administrative determination. If the tax matters partner does not seek judicial review, then the Tax Court would hear the case if any partner filed a petition in the Tax Court. Otherwise, the court in which the first petition for review was filed would retain jurisdiction.

To be within the jurisdiction of the Court of Claims or the District Court, a partner must pay to the Secretary the amount by which his tax liability would be increased if the Service's administrative determination were sustained. If a court other than the Tax Court acquires jurisdiction over the partnership's case, the IRS would be entitled to assess the additional tax liability allocable to the partner.

The proposal also contains rules analogous to the current provisions applicable to claims for refund. If a partner believes that an overpayment of tax is attributable to partnership items, the partner would be required to file an administrative adjustment request. If the request is filed by the tax matters partner, then the request will be considered to be filed on behalf of all partners.

Administrative proceedings related to such an administrative adjustment request will be conducted at the partnership level. If an administrative adjustment request is filed by a partner other than the tax matters partner, the IRS would be given the option to treat the request as an ordinary claim for refund by the particular partner. Alternatively, the IRS would be allowed to institute a partnership level proceeding.

Any changes in the tax liability of the partners attributable to partnership items will be subject to a special statute of limitations based upon the limitations rules now in effect generally. Assessments of any tax deficiencies at the partner level based on a final determination at the partnership level may be made at any time within one year after the partnership level determination has become final. Any extension of the partnership's limitations period may be consented to by the tax matters partner or by any other authorized person.

Dissenters' Rights

In drafting the proposal, significant care was taken to avoid prejudicing the rights of partners who disagree with strategic or legal decisions made by the other partners. Accordingly, the proposal incorporates substantial protection for so-called "dissenters' rights." Although dissenters' rights are preserved, care also has been taken to guarantee that all partners are treated equally and fairly; a dissenter would not be offered a more favorable settlement than other partners.

Incorporation of these protective provisions necessarily complicates the legislative draft. On balance, we believe that the cost incurred in terms of statutory complexity is more than offset by the benefits to be derived from ensuring that all partners are able to receive equitable treatment. It should be noted that the resulting statutory complexity will not necessarily lead to complex administrative problems. In most partnership audits, we anticipate that the dissenters' rights will not be exercised, and the procedures actually used will be quite simple. In those few situations where dissenters' rights are exercised, the procedure to be followed will be significantly simpler than current procedures.

The first significant dissenters' right involves the ability of the taxpayer to report partnership items inconsistently with the position reported by the partnership on its tax return. A tax return is signed under penalty of perjury. We do not believe that a taxpayer should be required to file a tax return that contains information believed to be incorrect. However, we are concerned that the IRS could be whipsawed if the inconsistent reporting is not brought to its attention.

The proposal balances these conflicting concerns in an equitable manner. Any partner would be allowed to report an item inconsistently with the reporting of the item on the partnership tax return without prejudice if the partner files a statement identifying the inconsistency. If the inconsistency is identified, the Service would have the option of initiating an audit of either the inconsistent partner or the partnership, or simply accepting the partner's return as filed. If the required statement is not filed, the IRS may treat the inconsistency as a computational error rather than as a deficiency, resulting in an immediate assessment of the tax due. In addition, failure to file the required notice of inconsistency may subject the partner to a negligence penalty.

A closely related dissenters' right is the ability of a partner to file an administrative adjustment request even if the other partners choose not to do so. This provision gives a partner the ability to challenge the position reported by the partnership even after an initial return is filed.

The second significant area where dissenters' rights are preserved involves settlements. It would be possible to treat a partnership as a strictly separate entity for procedural purposes. If this were done, the partnership would make all decisions concerning settlement strategy. This is precisely what is done with most corporations. However, we are concerned that giving the partnership total authority to bind the partners could prevent a partner from asserting a legitimate argument that is contrary to the position taken by the other partners. We are also concerned that the views of one or more partners having an insignificant interest in the partnership should not delay the remaining partners from resolving their tax disputes.

To protect the rights of the individual partners from both the tyranny of the majority and from the tyranny of the few, the proposal provides that the IRS may settle with one or more partners at any time, even if other partners refuse to settle. As stated earlier, the terms of such a separate settlement must be offered to all partners on a consistent basis. In addition, any partner possessing at least a 1 percent interest in the partnership profits, or a group of partners possessing in the aggregate at least a 5 percent interest, would be entitled to seek judicial review of the Service's final administrative determination. As discussed earlier, separate actions brought by more than one partner would be consolidated into a single proceeding.

Multi-tier and Foreign Partnerships

The proposal incorporates special rules for multi-tier partnerships and foreign partnerships. Under the proposal, a partner in a partnership that itself is a partner in a second partnership is treated as an indirect partner. Since the indirect partner is the party likely to pay any tax liability resulting from the audit of the second partnership, the indirect partner will be treated as a direct partner if the indirect partner is identified to the IRS in a timely manner. In the absence of timely identification, the indirect partner will be bound by actions taken by the appropriate "pass-thru" partner that has the direct interest in the partnership. The same rules will apply to taxpayers owning an indirect interest in the partnership through other "pass-thru" entities, such as trusts, estates and electing small business corporations.

The proposal also imposes reporting requirements on foreign-based partnerships. Under current law, foreign partnerships are not required to file information returns unless they are engaged in a trade or business in the United States. Where returns are not filed, the IRS has had difficulty verifying the income tax consequences of partnership transactions on United States partners. In response to this problem, the proposal would expressly require a foreign partnership to file a U.S. partnership return if any of its partners, whether limited or general, are U.S. persons. Failure to file the return could result in the disallowance of any losses and credits of a partner.

The Secretary would have the authority to issue regulations to waive the reporting requirement for foreign partnerships in appropriate and limited circumstances. This authority could be exercised, for example, to relieve the reporting burden with respect to joint ventures between a U.S. person and a foreign government if the latter is precluded by its internal law from complying with the reporting requirement. However, the mere existence of foreign bank secrecy laws would not justify a waiver of the reporting requirements.

The proposal also would require a U.S. person to file a return reporting its acquisition or disposition of an interest in, or substantial change in proportionate interest in, a foreign partnership. This provision would parallel similar reporting provisions under present law which relate to interests of U.S. persons in foreign trusts and corporations.

Subchapter S Corporations

Subtitle B of Title VI adopts procedural rules applicable to electing small business corporations that are quite similar to the rules applicable to audits of partnerships. Under the proposal, the tax treatment of any Subchapter S item will be determined at the corporate level. A shareholder in a Subchapter S corporation must treat all Subchapter S items consistently with the treatment of the item on the corporate tax return unless the taxpayer files a statement identifying the inconsistency. Under a broad grant of regulatory authority, more detailed rules will be established governing the procedures applicable to Subchapter S corporations.

Conclusion

The Treasury Department believes that the provisions incorporated in Title VI of H.R. 6300 would significantly improve the enforcement of the tax laws, and we strongly support these provisions.

MISCELLANEOUS

Issuance of Regulations

Under H.R. 5829, the Internal Revenue Code would be amended to require that rules and regulations necessitated by future Code amendments be issued "as soon as possible." H.R. 6300 contains no parallel provision.

I am not certain of the purpose for this provision. I have no hesitancy in saying that Treasury and IRS today issue all regulations "as soon as possible." Continual changes in the law, coupled with the need to consider carefully technical and policy issues and the views of affected taxpayers in the interpretation of complex statutory provisions, all delay the issuance of regulations. While I share the general concern about the backlog of regulations projects, I question the desirability of writing this measure into the public law.

Effective Dates

Other than the effective dates for the pension provisions, I have not in this statement attempted to comment systematically on the effective date of each of the many other provisions of these bills. I do wish to note, however, that it appears to us that early effective dates for certain of the provisions -- particularly, for example, where new reporting requirements are involved -- could create problems for persons required to comply with the requirements, as well as for the IRS. Just as an example, I note that under H.R. 5829 interest paid to taxpayers after December 31, 1981 on obligations of corporations issued in bearer form would be subject to reporting for the first time. Obviously, it would be difficult to comply with this requirement in many cases.

We would be happy to work with the Committee in devising effective dates which adequately take into account practical difficulties which could arise in implementing some of the provisions of these bills.

Revenue Estimates

The Office of Tax Analysis in the Treasury is currently in the process of estimating the revenue effects of the bills' provisions. These estimates are expected to be completed within the next three weeks. We will furnish these estimates for the record as soon as they are available.

Chairman Rostenkowski. Thank you, Mr. Chapoton.

Mr. Archer, you may proceed.

STATEMENT OF HON. GLENN ARCHER, JR., ASSISTANT ATTORNEY GENERAL, TAX DIVISION, U.S. DEPARTMENT OF JUSTICE

Mr. Archer. Mr. Chairman and members of the committee, I appreciate the opportunity to appear today to discuss the Tax Compliance Act of 1982. My testimony will be limited to two points, first, the importance of the administrative summons provisions contained in title I of H.R. 6300, and second, to the inadequacy of the current fine levels for criminal tax offenses.

With respect to administrative summonses, in 1976 Congress enacted a new set of procedures for IRS summonses seeking access to rec-ords and documents in the possession of banks and other third party recordkeepers. The new procedures were intended to afford taxpayers the right to challenge the summonses in court. To this end, section 7609 of the Internal Revenue Code now requires that notice of the summons be given to the taxpayer, and permits the taxpayer to prevent compliance with the summons by writing a letter to the bank or other recordkeeper.

The Service is then forced to initiate a summons enforcement proceeding in the district court in order to obtain access to the records needed to complete an investigation. Section 7609 affords the taxpayer the right to intervene in such an enforcement proceeding. Many taxpayers have abused the rights provided by section 7609 solely to delay and impede investigations and without any intention of using the procedure for its congressionally intended purpose—to present in court their objections to compliance with the summons.

The principal cause of delay stems from the provision which allows a taxpayer to obtain a stay of compliance merely by sending a letter of objection to the third party recordkeeper. The letter has the same effect as a judicial restraining order, and the Service is blocked from obtaining the required information until a court enters an enforcement order.

The Tax Division and the U.S. attorneys have the responsibility for seeking enforcement orders for IRS summonses. Our experience is that when a taxpayer's day in court arrives, generally many months after compliance has been stayed, and sometimes as long as a year later, a large proportion of these taxpayers stay at home and do not even appear at the judicial hearing. The end result is that no legitimate taxpayer purpose is served. On the other hand, there is an extremely undesirable delay in the Service's investigation, and an extraordinary waste of judicial, Justice Department, and IRS resources, all of which are limited, as you know.

H.R. 6300 would eliminate these unnecessary delays and burdensome waste of resources. The proposed legislation would require a taxpayer to institute a motion to quash action to stay compliance instead of requiring the IRS to file an enforcement action. The proposed procedure is similar to that which applies to all Government agencies other than IRS under the Right to Financial Privacy Act. Persons who do not intend to appear in court would no longer have a simple means of creating delay. We heartily endorse the enactment of the motion to quash procedure.

A second summons-related feature of H.R. 6300 deals with the use of summonses in criminal investigations. The Service's summons authority has its roots in the earliest revenue laws, and in its original manifestation, the authorizing legislation made an expressed reference to the use of summonses to investigate false and fraudulent returns, a criminal offense.

In the *LaSalle National Bank* case, a 5-to-4 decision of the U.S. Supreme Court, it was held that an administrative summons could be used in a criminal investigation, but only while a civil purpose also existed. The Court held that after the Service had made an institutional commitment to refer a criminal case for prosecution, or had recommended prosecution to the Justice Department, further use of a summons was impermissible. The dissenting opinion predicted that the institutional purpose test would spawn a significant amount of litigation in spite of a statement in the majority opinion to the contrary. The dissent would have ruled instead that a summons could be used for a criminal purpose at any time until the case had been referred to the Justice Department.

The prediction of significant amounts of litigation over this issue has proven to be accurate. By the same token, it has also been virtually impossible for taxpayers to preclude the entry of an enforcement order on the basis of the institutional commitment test. Thus, there has been a significant amount of litigation based on the *LaSalle* case, with, for practical purposes, no taxpayer successes, and as a result, the *LaSalle* case, we believe, has been used primarily for delay.

H.R. 6300 would expressly authorize the use of summonses for investigating criminal offenses connected with the administration or enforcement of the internal revenue laws. Under H.R. 6300 the summons authority could be used at any time prior to reference of a case to the Justice Department. This limitation on the summons authority essentially adopts the approach of the dissenting Justices in the *LaSalle* case. The bill would also allow the Service to use its summons authority if a criminal investigation is reopened by the Service after a prosecution has been declined or the case has been referred by the Justice Department back to the Internal Revenue Service.

These proposals are salutory. Their adoption would serve to cause criminal investigations to be made by the use of the administrative process. The Service currently has authority to use summonses in most of the Service's criminal investigations, but the Court engrafted restrictions permit futile challenges by taxpayers whose primary purpose is to obtain delay or otherwise impede the investigation. H.R. 6300 largely represents a codification of authority that the Service already has, but in more precise language which eliminates the litigation and the resultant delay spawned by the institutional purpose test.

A third summons proposal contained in H.R. 6300 requires that upon receipt of a third party recordkeeper summons, the third party must take immediate steps to assemble the records and be prepared to produce the requested records on the date specified in the summons. The proposal is designed to speed up the turnover of summons documents. This amendment is likewise beneficial and will aid the Internal Revenue Service in the conduct of its investigations, and should be enacted.

With respect to fines for criminal tax offenses, the maximum criminal fine authorized by the Internal Revenue Code is $10,000, and as you know, tax evasion is the most serious criminal tax offense.

The $10,000 fine level for tax evasion has remained unchanged since 1924 when it was raised from $1,000 by section 1017 of the Revenue Act of 1924. The current level of criminal tax fines does not comport with today's economic realities and, therefore restricts the ability of the courts to fashion sanctions reflective of the seriousness of the crime. At least when viewed from the standpoint of the maximum fine level, tax evasion has become a much less serious offense than it was 60 years ago when the $10,000 fine level was established. Yet in reality, the problem has grown more severe over the years.

Tax evasion and other forms of tax fraud do serious damage to our tax system and result in enormous revenue losses. There are numerous fraudulent schemes by which promoters, protest leaders, and others cause wide scale defrauding of the Treasury. On many occasions, the maximum fine of $10,000 is grossly disproportionate to these crimes. This is also true when the defendant is a corporation since imprisonment is not an available sanction for a corporation. The imposition of a $10,000 fine is hardly a severe punishment on a large corporation and, consequently does not provide any significant deterrent value.

While the enactment of new civil penalties proposed by H.R. 5829 and H.R. 6300 will help, civil penalties are not the sole answer since the imposition of fines and imprisonment generally receives greater publicity and provides a greater overall deterrent effect. And from the standpoint of timing, criminal proceedings are usually concluded at an earlier date than the civil proceedings.

In our view, in addition to enacting the proposed civil penalties, the maximum criminal fines for tax offenses should be significantly increased as well.

I recognize that the problem of inadequate fine levels is not limited to tax offenses. Many of the limitations on fines contained in the Criminal Code are also hopelessly outdated. Legislation to remedy the problem generally is and for a number of years has been under consideration in both the House and the Senate in connection with the overall modernization of the Nation's criminal laws, and the administration strongly supports legislation to reform our criminal laws.

However, pending enactment of the new Criminal Code, all versions of which presently have significant deferred effective dates in any event, we are convinced that immediate substantial increases in the fine levels for tax offenses should be enacted.

There are several possible approaches to updating the fine levels for criminal tax offenses. First, the Criminal Code legislation reported by the Senate Judiciary in January of this year would set maximum fine levels for felony violations, including tax offenses, as $250,000 for individuals and $1 million for corporations. These fine levels, however, are coupled with a systematic, consistent codification of the criminal laws, including new sentencing provisions and specific criteria to be considered by judges when imposing sentences.

While these fine levels are quite high, it is entirely appropriate for these limits to apply to tax fines in the context of an overall codification of the criminal laws. Tax evasion is no less serious than other forms of theft.

A second model is the Sherman Act. Since 1974, violations of the Sherman Act have carried maximum fine levels of $100,000 for individuals and $1 million for corporations.

A third model is the version of the Criminal Code legislation which passed the Senate in 1978. Under S. 1437, the Senate bill that year, felony violations, including tax offenses, were subject to maximum fines of $100,000 for individuals and $500,000 for corporations.

I submit that at a minimum the committee should consider raising the fine levels for tax offenses to the levels approved by the Senate in 1978, that is, $100,000 for individuals and $500,000 for corporations, and that appropriate adjustments should be made for other criminal violations including misdemeanors.

A fine level of $100,000 for individuals would represent a tenfold increase. While at first blush this change may appear to be overly dramatic, there is precedent for a tenfold increase in tax fines: in the Revenue Act of 1924, which raised the fine from $1,000 to $10,000; and the pending Criminal Code proposals which would provide for an even greater percentage increase.

A judge is presently restricted to imposing a fine of $10,000 whether the taxes evaded amounted to $20,000, $200,000 or $2 million. This fine structure does not adequately take into account the seriousness of tax fraud and its adverse impact on the tax system overall. A wide range of fines should be available to reflect the varying degrees of the crime and the severity of the sanction needed to punish the offender and to have a deterrent effect on other taxpayers.

Most would agree that a fine of $100,000 imposed on a narcotics trafficker who evaded large amounts of taxes was not too severe. There are also other aggravated cases of tax evasion involving large sums of legal sector income. Unscrupulous promoters of fraudulent schemes cause wide-scale defrauding of the public fisc and should be dealt with harshly. The solution is to provide the judiciary with greater flexibility by significantly raising the maximum fines for tax offenses.

Thank you for the opportunity to appear today. We would be pleased to work with the committee and its staff concerning our proposal for legislation in the criminal fine area.

Thank you.

[The prepared statement follows:]

STATEMENT OF HON. GLENN L. ARCHER, JR.

Mr. Chairman and Members of the Committee, I appreciate the opportunity to appear today to discuss the Tax Compliance Act of 1982. My testimony will be limited to two points: (1) the importance of the administrative summons provisions contained in Title I of H.R. 6300; and (2) the inadequacy of current fine levels for major criminal tax offenses.

ADMINISTRATIVE SUMMONS

In 1976, the Congress enacted a new set of procedures for I.R.S. summonses seeking access to records and documents in the possession of banks and other third-party recordkeepers. The new procedures were intended to afford taxpayers a right to challenge these summonses in court. To this end, Section 7609 of the Internal Revenue Code now requires that notice of the summons be given to the taxpayer and permits the taxpayer to prevent compliance with the summons by writing a letter to the bank or other recordkeeper. The service is then forced to initiate a summons enforcement proceeding in district court in order to obtain the records needed to complete the investigation. Section 7609 affords the taxpayer the right to intervene in such proceedings.

Many taxpayers have abused the rights provided by section 7609 solely to delay and impede investigations and without any intention of using the procedure for its congressionally intended purpose—to present in court their objections to compliance. The principal cause of delay stems from the provision which allows a taxpayer to obtain a stay of compliance merely by sending a letter of objection. The letter has the same effect as a judicial restraining order and the service is blocked from obtaining the required information until a court enters an enforcement order.

The Tax Division and the United States attorneys have the responsibility for seeking enforcement orders for I.R.S. summonses. Our experience is that when the taxpayer's day in court arrives—generally many months after compliance has been stayed and sometimes as long as a year later—a large proportion of taxpayers stay at home and do not appear. The end result is that no legitimate taxpayer purpose is served. On the other hand, there is an extremely undesirable delay in the service's investigation and an extraordinary waste of judicial, Justice Department and I.R.S. resources, all of which are limited, as you know.

H.R. 6300 and other bills before the committee (H.R. 1501 introduced by Mr. Gibbons; H.R. 3065, introduced by Mr. Evans (Ga.); and H.R. 4160, introduced by Mr. Rinaldo) would eliminate these unnecessary delays and the burdensome waste of resources. The proposed legislation would require a taxpayer to institute a motion to quash action to stay compliance instead of requiring the I.R.S. to file an enforcement action following stay of compliance by letter. The proposed procedure is similar to that which applies to all government agencies other than the I.R.S. under the Right to Financial Privacy Act of 1978 (12 U.S.C., Sec. 3401, *et seq.*). Persons who do not intend to appear in court would no longer have a simple means of creating delay. Compliance would be stayed only for persons who demonstrate at the outset an intention to participate in the judicial proceeding. We heartily endorse the enactment of the motion to quash procedure.

A second summons-related feature of H.R. 6300 deals with the use of summonses in criminal investigations. The service's summons authority has its roots in the earliest revenue laws and in its original manifestation, the authorizing legislations made an express reference to the use of summonses to investigate "false and fraudulent" returns, a criminal offense. Act of June 30, 1864, c. 173, 13 Stat. 223, 226, Sec. 14. In *United States* v. *LaSalle National Bank*, 437 U.S. 298 (1978), a five-to-four decision, the Supreme Court found that an administrative summons could be used in criminal investigations, but only while a civil purpose also existed. The Court held that after the service had made an institutional commitment to refer a criminal case for prosecution or had recommended prosecution to the Justice Department further use of a summons was impermissible. The dissenting opinion predicted that the "institutional purpose" test would spawn a significant amount of litigation, in spite of a statement on the majority opinion that the test would ultimately bar the use of summonses on only rare occasions. The dissent would have ruled instead that a summons could be used for a criminal purpose at any time until the case had been referred to Justice. The prediction of significant amounts of litigation over this issue has proven to be accurate. By the same token, it has also been virtually impossible for taxpayers to preclued the entry of an enforcement order on the basis of the institutional commitment test. The litigation by taxpayers based on the *LaSalle* case has been used primarily for delay.

H.R. 6300 would expressly authorize the use of summonses for investigating criminal offenses connected with the administration or enforcement of the internal revenue laws. Under H.R. 6300, the summons authority could be used at any time prior to reference of a case to the Justice Department. this limitation on the summons authority essentially adopts the approach of the dissenting Justices in the *LaSalle* case. The bill would also allow the Service to use its summons authority if a criminal investigation is reopened by the Service after prosecution has been declined by the Justice Department. These proposals are salutory. Their adoption would serve to cause criminal tax investigations to be made by the use of the administrative process rather than by the grand jury process. The Service currently has authority to use summonses in most of the Service's criminal investigations, but court engrafted restrictions permit futile challenges by taxpayers whose primary purpose is to obtain delay or otherwise to impede the investigation. H.R. 6300 largely represents a codification of authority that the Service already has, but in more precise language which eliminates the litigation and resultant delay spawned by the "institutional purpose" test.

A third summons proposal contained in H.R. 6300 requires that upon receipt of a Section 7609 summons, a third-party recordkeeper must take immediate steps to assemble the records and be prepared to produce the requested records on the date specified in the summons. The proposal is designed to speed up the turnover of summoned documents either in the absence of a judicial proceeding or at the conclusion of the proceeding. This amendment is likewise beneficial, will aid the Service in the conduct of investigations, and should be enacted.

CRIMINAL FINES

The maximum criminal fine authorized by the Internal Revenue Code is $10,000 and, as you know, tax evasion (Code Sec. 7201) is the most serious criminal tax offense. the $10.000 fine level for tax evasion has remained unchanged since 1924 when it was raised from $1,000 by Section 1017 of the Revenue Act or 1924. Ch. 234, 43 Stat. 253, 343–44.

The current level of criminal tax fines clearly does not comport with today's economic realities and, therefore, restricts the ability of courts to fashion sanctions reflective of the seriousness of the crime. At least when viewed from the standpoint of the maximum fine level, tax evasion has become a less serious offense than 60 years ago when the $10,000 fine level was established. Yet, in reality, the problem has grown more severe over the years.

Tax evasion and other forms of tax fraud do serious damage to our tax system and result in enormous revenue losses. There are numerous fraudulent schemes by which promoters, protest leaders or others cause wide-scale defrauding of the treasury. On many occasions the maximum fine of $10,000 is grossly disproportionate to the crime. This is also true when the defendant is a corporation, since imprisonment is not an available sanction for a corporation. the imposition of a $10,000 fine is hardly a severe punishment and, consequently, does not provide any significant deterrent value.

While the enactment of the new civil penalities proposed by H.R. 5829 and H.R. 6300 will help, civil penalities are not the sole answer, since the imposition of fines and imprisonment generally receives greater publicity and provides a greater overall deterrent. And from a standpoint of timing, criminal proceedings are usually concluded at an earlier date. In our view, the maximum criminal fines for tax offenses should be significantly increased as well.

I recognize that the problem of inadequate fine levels is not limited to tax offenses. Many of the limitations on fines contained in the Criminal Code (18 U.S.C.) are also hopelessly outdated. Legislation to remedy the problem generally is, and for a number of years has been, under consideration in both the House and Senate in connection with overall modernization of the nation's criminal laws and the Administration strongly supports legislation to reform our criminal laws. However, pending enactment of the new Criminal Code, all versions of which presently have significant deferred effective dates in any event, we are convinced that immediate, substantial increases in the fine levels for tax offenses should be enacted.

There are several possible approaches to updating the fine levels for criminal tax offenses. First, the Criminal Code legislation reported by the Senate Judiciary Committee in January of this year, measures under study by the House Judiciary Subcommittee on Criminal Justice (H.R. 1647, H.R. 4711, H.R. 5679 and H.R. 5703), and legislation reported by the House Judiciary Committee on the 96th Congress (H.R. 6915) would set the maximum fine levels for felony violations, including tax offenses, at $250,000 for individuals and $1,000,000 for corporations. These fine levels, however, are coupled with a systematic, consistent codification of the criminal laws, including new sentencing provisions and specific criteria to be considered by judges in imposing sentence. While these fine levels are quite high, it is entirely appropriate for these limits to apply to tax fines in the context of an overall codification of the criminal laws—tax evasion is no less serious than other forms of theft.

A second model is the Sherman Act (15 U.S.C., Section 1, 2 and 3). Since 1974, violations of the Sherman Act have carried maximum fine levels of $100,000 for individuals and $1,000,000 for corporations.

A third model is the version of the Criminal Code legislation which passed the Senate in 1978 (S. 1437). Under S. 1437, felony violations, including tax offenses, were subject to maximum fines of $100,000 for individuals and $500,000 for corporations.

I submit that at a minimum the Committee should raise the fine for tax offenses to the levels approved by the Senate in 1978—$100,000 for individuals and $500,000 for corporations.[1] A fine level of $100,000 for individuals would represent a tenfold increase. While at first blush this change may appear to be overly dramatic, there is precedent for a tenfold increase in tax fines. The Revenue Act of 1924 raised the fine from $1,000 to $10,000. The pending Criminal Code proposals would set even significantly higher levels.

A judge is presently restricted to imposing a fine of $10,000, whether the taxes evaded amounted to $20,000, $200,000 or $2,000,000. this fine structure does not adequately take into account the seriousness of tax fraud and its adverse impact on the tax system overall. A wide range of fines should be available to reflect the varying degrees of the crime and the severity of the sanction needed both to punish the offender and to have a deterrent effect on other taxpayers. Most would agree that a fine of $100,000 imposed on a narcotics trafficker who evaded a large amount of taxes was not too severe. There are also aggravated cases of tax evasion involving large sums of "legal sector" income. Unscrupulous promoters of fraudulent schemes cause wide-scale defrauding of the public fisc and should, likewise, be dealt with harshly.

The solution is to provide the judiciary with greater flexibility by significantly raising the maximum fines for tax offenses.

Thank you for the opportunity to appear today. We would be pleased to work with the Committee and its staff concerning this legislation.

[The following letter was subsequently received:]

---

[1] Appropriate adjustments should also be made for other criminal violations of the revenue laws, including misdemeanors.

U.S. Department of Justice

Tax Division

Assistant Attorney General

Washington, D.C. 20530

JUN 23 1982

COMMITTEE ON
JUN 24 1982
WAYS AND MEANS

Honorable Dan Rostenkowski
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

In testimony before the Ways and Means Committee last month concerning tax compliance measures (H.R. 5829 and H.R. 6300), I recommended that the criminal fine levels of the Internal Revenue Code be updated to reflect current economic realities. Committee staff has requested that I amplify the comments contained in the testimony.

The thrust of my testimony was that the current criminal fine levels for tax offenses are archaic and that the maximum fine of $10,000 is grossly disproportionate to the crime on many occasions. I recommended the maximum crime fine be raised from $10,000 to $100,000 for individuals and $500,000 for corporations. The higher fine level for corporations is needed because imprisonment is not an available sanction as to a corporation. These fine levels are identical to the general criminal fine levels for felonies approved by the Senate in 1978 as part of an overall revision of the criminal laws.

My testimony did not make specific recommendations concerning fine levels other than for tax evasion. I merely said that appropriate adjustments should be made in the fines for other revenue offenses. Your staff has asked that I make specific recommendations in this respect. I understand that the Committee expects to consider the tax compliance legislation shortly.

The major concern of the Tax Division and of the Internal Revenue Service is with the fine levels for the types of violations which comprise most of our criminal case inventory. In addition, to the offense of tax evasion (Code Section 7201), the primary violations involve false statement or the aiding and abetting in a false statement (Code Section 7206) and failure to file a return (Code Section 7203). There are also some prosecutions for the filing of a false document (other than a return) (Code Section 7207). The current maximum file levels for these offenses are $5,000 under Section 7206, $10,000 under Section 7203 and $1,000 under Section 7207. Section 7206 offenses are felonies; violations of Sections 7203 and 7207 are misdemeanors.

In my view, the maximum fine for violation of Section 7206 should be identical to the fine for violation of Section 7201. Prosecutions under Section 7206 often involve fraudulent schemes by which promoters, protest leaders and others cause wide-scale defrauding of the treasury by inducing numerous other persons to violate the law. Charges are also prosecuted under Section 7206 where a fraudulent tax return is filed, but we are unable to prove the existence of a tax deficiency. The offenses covered by Section 7206 are no less serious than tax evasion and the fine levels should be the same. In this respect, it should be noted offenses described by Sections 7201 and 7206 would have identical maximum fine levels under the criminal code legislation pending before the House and Senate Judiciary Committees.

The Internal Revenue Code has traditionally imposed the same maximum fine level for violations of Code Section 7203 (failure to file) as for tax evasion in spite of the fact that failure to file a return is a misdemeanor and tax evasion has been a felony since 1924. Our experience, however, is that judges impose the maximum fine of $10,000 for failure to file a return only in very aggravated situations. Thus, continued retention of the symmetry between Sections 7201 and 7203 would not have any practical consequence. On the other hand, some increase is needed to reflect the seriousness of failing to file tax returns. On balance, my recommendation is that the fine be set at $25,000 for an individual and $100,000 for a corporation. These fine levels are consistent with the provisions of the criminal code legislation presently pending in the Senate Judiciary Committee. The correlative bills pending before the House Judiciary Committee would impose a maximum fine of $25,000, but no distinction would be made between individuals and corporations.

Section 7207 is entitled "Fraudulent returns, statements or other documents." The provision is used only in false document cases, usually where altered substantiating documents are supplied to an agent during an audit. The Tax Division does not authorize prosecution under Section 7207 in cases where a false tax return was filed. We urge that the present fine level of $1,000 for this offense be raised to $10,000 for individuals and $50,000 for corporations. In addition, Section 7207 should be amended by striking the term "return" from the text and the caption. This technical amendment would conform the description of the offense to the current practice of the Service and the Tax Division in prosecuting cases under this provision.

There are other criminal provisions in Chapter 75 of the Code. Prosecutions for these offenses are infrequent, however, in comparison to the offenses discussed above. Criminal provisions are also contained in Chapters 51, 52 and 53 of the Code (relating to alcohol, tobacco and firearms) and Chapters 95 and 96 (relating to financing of Presidential Election Campaigns). The criminal code legislation pending in the Senate Judiciary Committee (S. 1630) could be used as a model for modifying the fine levels contained in these provisions. The fines which we recommend for offenses under Sections 7201 and 7206 could be applied to all tax felonies and the fine levels for offenses under Section 7203 could generally be applied to misdemeanors. However, there are a significant number of provisions involved and even the criminal code legislation does not deal with every criminal tax provision. I also recognize that time is very limited. Under the circumstances, it would seem preferable to limit the focus of the Committee to offenses involving Sections 7201, 7203, 7206 and 7207. These offenses comprise the bulk of our criminal tax cases, and the remaining provisions could be addressed by the Committee at a later date or could await enactment of the comprehensive legislation to modernize the Nation's criminal laws.

I appreciate the Committee's interest in our recommendation. My staff and I will be pleased to assist the Committee in any way that we can.

Sincerely yours,

GLENN L. ARCHER, JR.
Assistant Attorney General
Tax Division

Mr. Pickle [presiding]. Thank you, Mr. Archer, for your testimony and the other gentlemen, also.

Let me ask the members of the committee if anyone has questions of the panel.

Mr. Duncan?

Mr. Duncan. Thank you, Mr. Chairman.

I have one for Mr. Egger, if he would, please.

There has been much speculation that a great deal of the so-called compliance gap is traceable to illegal income, but if I understood you correctly, you provided really the opposite information in your testimony because I think you said that $87 billion of the compliance gap is traceable to legal income. That means that 90 percent of the gap involves entirely legal income, and the percentage attributable to illegal income is therefore relatively small compared to the information we have been receiving in the past.

Am I correct in these figures, or do you have additional comments that you care to make on the subject?

Mr. Egger. Basically your statement is correct, Mr. Duncan. I would like to supplement it just a bit.

To begin with, our ability to estimate the amount of income from illegal sources, that is not taxed is very, very difficult. We do not have any really reliable way of being able to be sure that we have a good handle on all of that amount, and it could be considerably more than we have estimated. So we are having to go on the basis of the facts as we have been able to uncover them over a period of years.

But without question, far and away the vast majority of the tax gap is due to unreported or underreported income which is from legal sources.

Mr. Duncan. In dollars, what do you estimate the tax loss is in illegal income?

Mr. Egger. At this time it is probably in the range of around $8 billion a year, $8 billion to $9 billion.

Mr. Duncan. Thank you very much.

Thank you, Mr. Chairman.

Mr. Pickle. Do other members have questions?

Mr. Guarini?

Mr. Guarini. Thank you, Mr. Chairman.

Mr. Chapoton, one of the largest problems according to the IRS is the inadequacy of the reporting on capital gains taxes. As I understand it, according to their statistics, they estimate that 56 percent of all capital gains in this country is not reported. We do not have any really fixed reporting system as we do with income on 1099's and other types of reports that are required where you have personal income.

Is there any thought given, and what provisions are suggested by the IRS, to see to it that the government does in fact have a fuller compliance on capital gains taxes paid to the U.S. Government?

Mr. Chapoton. Yes, Mr. Guarini. The provisions of both bills, both H.R. 5829 and H.R. 6300 deal with that problem. H.R. 6300 in particular requires reporting of gross amounts on capital and stock transactions, securities transactions. Those provisions have been reviewed closely with the IRS, and the IRS thinks it can use that information and it would revise the Schedule D to do so. So basically that—the provisions of H.R. 6300—would go directly to that problem.

Mr. **Guarini**. That is very general. I am wondering whether or not there are any forms that are going to be required by the IRS to see to it that in our computer we can pick up everything that does relate to capital gains.

Mr. **Chapoton**. It would require reporting by the brokerage house to the IRS with a copy to the individual.

Mr. **Guarini**. What about realty?

Mr. **Chapoton**. No, real estate and other transactions are not dealt with, and I want to point out that a large portion of capital transactions are not on the stock markets, so there is no provision in either of these bills dealing with that. We simply have not come up with a method of dealing with that.

Mr. **Guarini**. Do you think some consideration should be given to real estate where if someone does sell a piece of property, that the attorney is required to file a report, just as he would be required to file with the local registrar a report concerning the value of the property for tax assessment purposes, which is often the case in most of our states?

Mr. **Chapoton**. I would refer to Mr. Egger on that. He has been giving some thought to that.

Mr. **Guarini**. We are talking about billions of dollars that we give up here.

Mr. **Egger**. We are experimenting right now with the utilization of information that is already available in the private sector, and the indications are that we will be able to make considerable use of that kind of information without having to develop further reporting requirements because the information that is available is quite complete.

Mr. **Guarini**. Every piece of real estate, virtually, is sold through an attorney, and it would be very easy to have him require a report as we require a report of an investment house as to the property that is being sold, and if that makes a difference of billions of dollars which we need at this time, it would be worth giving consideration to.

Mr. **Egger**. Essentially all of the sales transactions where property changes hands is recorded in almost every jurisdiction in the country, and the recordation records themselves, together with the amount of information from those records that is available in the private sector is, we think, going to be very useful.

Mr. **Guarini**. But there would be a lot of work culling it out unless you put responsibility on one particular group like an investment house has to make a report. If you find the responsible group that would make a report, whether it be title companies or attorneys or whatever, we would pick up a great deal.

Mr. **Egger**. What I am saying is that a good bit of that work has been done in the private sector in order to assist those in the industry, and we are analyzing that information that has already been made available, and we think it is going to be very helpful.

Mr. **Guarini**. Right. Thank you very much.

Mr. **Pickle**. In line with the previous question, let me get for the record, if I may, an estimate of the income or the savings amount to be made from this bill. It has been estimated that the entire bill would bring increased revenues of as much as $3 billion to $4 billion. There are six titles.

Can you tell us how these savings would be allocated by title? Can you give us that?

Mr. **Chapoton**. Mr. Pickle, we will be able to do that. Thus far our work has been on H.R. 5829 and we are working on a breakdown of the revenue, but we do not have it in final form.

Mr. **Pickle**. When might we have it?

As one member, I do not expect you to give us an ironclad figure, but in general, we hope to know by title allocation what can be saved.

When will you be able to make that available?

Mr. **Chapoton**. I think we will be able to have a figure for you next week.

[The following information was subsequently received:]

THE EFFECT OF THE TAX COMPLIANCE ACT OF 1982 (H.R. 6300) ON FISCAL YEAR RECEIPTS

[In millions of dollars]

	Fully effective 1983	Fiscal years—					
		1982	1983	1984	1985	1986	1987
Title I—Crimes, abusive tax shelters, fraud, etc.:							
Sec. 101—Jeopardy and termination assessments	19		19	21	22	24	26
Sec. 111—Penalty for promoting abusive tax shelters	17		17	2	(1)	(1)	(1)
Sec. 112—Injunctive relief against promoters of abusive tax shelters [2]	(1)		(1)	(1)	(1)	(1)	(1)
Sec. 121—Fraud penalty	(1)		(1)	(1)	(1)	(1)	(1)
Sec. 122—Penalty for documents understating tax liability	5		5	5	6	6	6
Sec. 123—Frivolous return penalty	10		(1)	10	3	(1)	(1)
Sec. 131—Third party summonses	(1)		(1)	(1)	(1)	(1)	(1)
Sec. 132—Third party recordkeeper requirements	(1)		(1)	(1)	(1)	(1)	(1)
Sec. 133—Limitation on administrative summonses	(1)		(1)	(1)	(1)	(1)	(1)
Total, title I	51		41	38	31	30	32
Title II—Improved information reporting:							
Sec. 201—Transactions involving certain obligations [3]	917		90	465	735	1,066	1,386
Sec. 202—Broker information reporting	288		22	120	209	320	389
Sec. 203—Payments to nonemployees	29		10	31	34	38	41
Sec. 204—State and local income tax refunds	273		65	174	273	358	393
Sec. 205—Casualty reimbursement	213		27	142	237	324	373
Sec. 211 and Sec. 212—Penalties for failure to comply with information return requirements	368		33	156	346	447	506
Sec. 213—Withholding on certain payments	32			3	16	28	40
Total, title II	2,120		247	1,091	1,850	2,581	3,128
Title III—Pensions and Other Retirement Income:							
Sec. 301—Withholding on pensions	1,538		1,096	1,355	1,717	2,161	2,416
Sec. 311—Penalty for premature IRA distributions	(1)		(1)	(1)	(1)	(1)	(1)
Sec. 312—Partial IRA rollovers	(1)		(1)	(1)	(1)	(1)	(1)
Total, title III	1,538		1,096	1,355	1,717	2,161	2,416

THE EFFECT OF THE TAX COMPLIANCE ACT OF 1982 (H.R. 6300) ON FISCAL YEAR RECEIPTS—Continued

[In millions of dollars]

	Fully effective 1983	Fiscal years—					
		1982	1983	1984	1985	1986	1987
Title IV—Transactions outside the United States:							
Sec. 401—Jurisdiction in the cases of persons outside the United States	NA		NA	NA	NA	NA	NA
Sec. 411—Penalty for failure to file foreign corporation information returns	NA		NA	NA	NA	NA	NA
Sec. 412—Returns with respect to foreign personal holding companies	NA		NA	NA	NA	NA	NA
Total, title IV	NA		NA	NA	NA	NA	NA
Title V—Modification of interest provisions:							
Sec. 501—Interest compounded daily	360		7	167	283	237	180
Sec. 502—Restrictions on interest payments [3]	554		492	498	463	431	379
Sec. 503—Interest surcharge for substantial understatement [4]	397		89	331	391	360	334
Total, title V	1,311		588	996	1,137	1,028	893
Title VI—Tax treatment of partnership and Subchapter S items: Secs. 602, 603, 604, 611 [2]							
Total, title VI							
Grand total	5,020		1,972	3,480	4,735	5,800	6,469

[1] Negligible.

[2] The Internal Revenue Service expects substantial saving in resources as a result of this provision.

[3] Estimate assumes Sec. 102—Registration of certain obligations.

[4] Estimate assumes daily compounding.

Note: NA: Not available

Source: Office of the Secretary of the Treasury; Office of Tax Analysis: June 24, 1982.

Mr. PICKLE. Thank you.

I guess before I proceed on the questioning, let me ask you about one other concern.

With respect to title III, withholding on pension payments, I am concerned about how this proposal will work. It seems to me if you enter into a withholding procedure, the cost of actually withholding or administering it might be considerable, and if that is so, then someone has to pay for it. This might mean the plan benefits would be less.

If you enter into this, will not retirees in effect have to pay for it?

Mr. CHAPOTON. Well, there will be some additional cost, and that is one of the items we always look at when we talk about both information reporting increases and any type of withholding. The problem in the pension area, though, is a lot of pensioners do not realize that they are incurring a tax liability. For the first time they will be pushed into the requirement of making an estimated tax return. There is a provision in the law now which permits them to elect withholding, and if they do so the same expense arises. But this would improve the elective provisions.

We talked to the industry groups, and basically I think this one-time type election is preferable to them even though you are right, there will be some cost.

Mr. **Pickle**. I need an estimate from you. What do you think it will cost to administer the withholding measure? Admittedly, if pensioners do make an election, at least there would be some certainty, but there would also be a cost involved, and I do not want to see the costs eat up the savings.

Mr. **Chapoton**. Right. I think the best thing we can do is diminish the number of elections. H.R. 6300 attempts to do that. It is a one-time election. If it is in effect, it stays in effect. But we will attempt—I am not sure that we can tie down the cost very closely on that—but we can attempt to give you a figure.

Mr. **Pickle**. That is fine.

Now, do I have other members with questions?

Mr. Pease?

Mr. **Pease**. Thank you very much, Mr. Chairman.

Mr. Chapoton, you have endorsed on behalf of the administration the proposals for increased reporting requirements for bonds and that sort of thing.

As I recall you came before this committee earlier this year proposing to require withholding from interest on savings accounts. One of the reasons used to justify that was that the IRS does not and I guess cannot make effective use of the reporting requirements that are already in the law. If that is the case, what is to lead us to believe that adding to the reporting requirements would significantly increase the chances for proper compliance?

Mr. **Chapoton**. Mr. Pease, our discussion on withholding versus reporting earlier this year and now remains the same. Withholding is a much more effective means of collection of tax than information reporting. But there are a lot of problems in adopting a withholding system, both political problems and cost problems.

We are now supporting expanded withholding—excuse me, expanded information reporting in lieu of withholding. In each case we are attempting to design the information reporting system so it will be as effective as possible.

But I have to tell you that it will never be as effective from a tax administrator's standpoint as a withholding system.

Mr. **Pease**. Thank you.

Mr. Egger, is it a fair charge that the IRS does not make effective use of the information it currently gets under the law for reporting requirements?

Mr. **Egger**. We have made great strides in that in the past few years, Mr. Pease. Right now we are matching up about 81 percent of all of the information reports that we receive. Part of our difficulty has been the need to upgrade the data processing capabilities of Internal Revenue, and that is in the mill right now. We are in the process of doing that. We are also well underway in developing new state-of-the-art techniques so that given the appropriate amount of resources and enough time to develop the techniques, we believe that we will achieve a very, very high percentage of matchup on all information reports over the near term.

I think it is safe to say two things about it. One is we are matching almost all of the information and the other is that there is a degree of compliance that is inherent simply because a taxpayer receives, at the return preparation period, information relative to the amount he should report and is aware, of course, that that amount is being reported to the Internal Revenue Service.

Mr. **Pease**. First of all, when do you expect this new computer capability to be on line?

Mr. **Egger**. Well, we are in the process of doing it right now. We have a whole series of systems development efforts, one of which is the equipment replacement program in our service centers. The first new computer is already installed in Memphis and four more are going to be installed in August through December of this year. The five remaining service centers will receive new computers in 1983 when all of that major replacement will be complete.

Other systems developments are of a considerably smaller nature but nevertheless very, very important.

I think the main thing we are trying to work with right now is the ability to receive information in a form such as a magnetic media that we do not have to manually keypunch in all the information. So, we are using two techniques there. One is to try to receive as much of that on magnetic media as possible from reporting groups, and the other one is to experiment with and attempt to develop the machine-readable type of documentation so that we can read it into the system automatically.

Mr. **Pease**. Thank you.

Mr. Egger, I think the figure quoted earlier this year as to the loss of revenue because of underreporting of investment income was $7½ billion a year, in that range. Is that about right?

Mr. **Egger**. It is somewhere in that range, $7 billion to $8 billion.

Mr. **Pease**. The question I want to get to before my time runs out is that if you are currently matching up 81 percent of all the information you get in, does that mean that the remaining 19 percent accounts for the $7 billion to $8 billion a year revenue loss?

Mr. **Egger**. One of the problems is, even to the extent that we match up, we are not always able to match all of the detail on a given return.

Right now, for example, to the extent that we do not receive all of the 1099's on a particular taxpayer, we prevent the system from working on a 100 percent basis. So, we have to achieve an improvement in the compliance portion, that is, in the actual reporting, and we believe that when that is accomplished—and we think it would be under H.R. 6300 and the other bills—that our effectiveness there will be considerably improved.

Mr. **Pickle**. The time of the gentleman has expired.

Do other members have questions?

Mr. Moore?

Mr. **Moore**. Thank you, Mr. Chairman.

I want to follow up on your questions and be sure that we get those answers as to what the savings will be in title III and what the costs will be for administering title III that will ultimately be borne by the pensions.

I should like to add, that my understanding, under existing law, is that the payors of benefits under IRA's or pension plans or whatever currently file forms, W-2P and 1099R with the Service, and I am wondering why we need to withhold.

Would it not be possible—maybe this is touching on the answers you were giving Mr. Pease—why can we not ultimately have some way of matchup under the computer system where you just simply take these forms being filed and check and see if the taxpayers pay taxes on it rather than go the withholding route?

Mr. Egger or Mr. Secretary?

Mr. CHAPOTON. Let me take a shot at that first, Mr. Moore.

In the first place, there is permissible voluntary withholding on pension distributions now, even though there is information reporting as well. This would, we think, improve the voluntary system. As I mentioned earlier, you simply do not do as well with information reporting as you do with a withholding system.

In addition, a withholding system, particularly for this class of taxpayers, is a most convenient way for them to pay tax. Many of them now elect, and I think by and large this system is considered an improvement from that end as well.

But let's assume there is not withholding and that you have a perfect information system. You then can immediately see the resources it would take to pursue inconsistencies once you match up. And that those resources are consumed even assuming the system were perfect cannot be overlooked.

Mr. MOORE. Well, this is what is troubling me. Why do we file these forms if they are not going to be used or matched up? What is the problem here? Can we not get them matched up to where you have a taxpayer's name and you have 1099's coming in from banks and IRA's and pension plans and wherever else? You cannot match that up and tell who is paying taxes and who is not?

Mr. EGGER. We can match them up, Mr. Moore. The problem is, No. 1, the quality of the reporting. We have a lot of small employers who are reporting. We fail to get a lot of the reports, and many of them come in in such shape that it is much too expensive in terms of people power to try to pursue it. They come in without identification numbers, they come in without—sometimes without names on them and so on and so forth. So, the quality of the reporting is one of the problems.

The second thing is that, even though we get a report, here again we have to determine at what level we can pursue each and every one of those, because of the relatively small amounts involved in some cases, and it becomes simply too expensive to try to put through the entire enforcement system. So, as a consequence we are simply unable to follow up on every single one of them, even where we are matching them up.

Mr. MOORE. Well, it seems to me, and, of course, you know this far better than I do, that you could have a standardized small IBM-type 1099 form with the name of the payor, the name of the payee, and the amount of the money, and submit that so that it can be keypunched into the computer system to show up.

What I am concerned about is the fact that, and I agree with you, it is probably more efficient to withhold everybody's pension income and let them come to the IRS to get their money back. That is certainly more efficient. On the other hand, I am worried about the loss of the use of that money we are going to cause people who are retired, who can ill afford it.

The same argument you heard in years past about dividend and interest withholding I think applies here. I am worried about the folks on a limited income suddenly losing the use of that income while they file to get their money back.

Mr. **Egger**. As you know, the bill provides for an option on the part of the pensioner to elect out of withholding.

Mr. **Moore**. I realize that. That is the only way it is even feasible for us to pass. I think that is right. But I am still concerned. What about those people who become confused because they think this is what they ought to do or they have been advised to do this and they do it; and they consistently have to go back to the IRS to get back their money? As they get older, they may consistently have to go to tax preparers and pay a fee to get the tax return prepared in order to get their money back, and then to wait on it; and they've lost the use of that money in the interim.

Mr. **Egger**. I think, frankly, they have more problems right now because they are not getting the information from the plan managers in many, many cases, and as a consequence there is a great deal of confusion as to how much they should be reporting.

Many of them get caught in the penalty structure for failure to pay in on a quarterly basis, because many of them go from a withholding situation into one where there is no withholding and they do not understand that they are required to pay it in on a pay-as-you-go basis. So quite frankly, as we view it with the election out we think that most of the pensioners who will stay in the withholding system will find it easier to simply have it withheld and paid as they go along than they would to prepay it themselves.

Mr. **Moore**. Is there a way that we can eliminate from withholding those who do not have a tax liability without having to voluntarily agree to not withhold or——

Mr. **Egger**. Withholding will be on the same basis as salaries and wages, which will mean that the pensioner has the option to adjust the amount of withholding up or down so as to meet his or her requirements.

Mr. **Moore**. Thank you.

Mr. **Pickle**. The time of the gentleman has expired.

Does any other member have any questions? The Chair will recognize you, Mr. Martin.

Let me remind the members that we have six panels today and we want to get all the testimony on record. We will ask each member to stay within their time.

Mr. Martin?

Mr. **Martin**. Am I recognized, Mr. Chairman?

Mr. **Pickle**. You are recognized.

Mr. **Martin**. Thank you very much, Mr. Chairman.

I have been interested in the testimony of today's witnesses. Generally, it has focused on the statistical analysis of the problem, showing the relative components and the nature of the problem. It discusses also proposed enforcement mechanisms in terms of which ways will work in what manner.

It occurs to me that it would be very valuable to the committee and to the Congress to have some thoughts from the witnesses regarding what we might refer to as causes of the problem. And I do not mean that in a trite sense. It occurs to me that one problem might be the increasing complexity of the Tax Code. Although the majority of citizens, of taxpayers, take the short form, nevertheless there seems to be an increasing momentum of discussion around the country in favor of simplified tax reporting.

The second reason seems to me to be related to earlier evidence that automatic bracket creep; that is, the effect of inflation moving people into higher and higher tax brackets each year, has been estimated in previous testimony to be very profound over the last decade or so. This phenomenon might have an effect in discouraging voluntary compliance with a system that used to be heralded for its effectiveness as a voluntary means of compliance.

I wonder if the witnesses would have any commentary as to what they have found with regard to the effects of complexity or bracket creep or other evidence which might have contributed to this increase in noncompliance.

Mr. CHAPOTON. Mr. Martin, if I might respond to that, one of the things that immediately jumps out at you as you review this very far-reaching information reporting/penalty change-type legislation is how little effect it will indeed have on the revenue lost from the tax gap.

Mr. MARTIN. How little effect?

Mr. CHAPOTON. How little it will do. There is still a big problem out there.

Mr. MARTIN. To increase the compliance enforcement?

Mr. CHAPOTON. That is correct.

Mr. MARTIN. So you say there is another problem that is not touched by it?

Mr. CHAPOTON. The problem is—I think you have alluded to it—the problem I would put in three categories:

One certainly is the complexity of the tax system;

Second is, quite possibly, the perceived inequity of the tax system, which encourages taxpayers to feel easier about avoiding tax;

And the third is the one you mentioned, of taxpayers having been moved into higher and higher tax rates. Where the median income family was in a 17-percent marginal rate in 1955, it would be in a 25-percent or higher marginal tax rate from here on out. When taxpayers are moved into higher and higher brackets, indeed into brackets that were initiated for taxpayers in the very upper income levels, then you exacerbate the concerns about the tax system and their willingness to do something about their tax liability, either through a tax shelter or avoidance or in some cases evasion.

So, I think those are concerns that we should address, this committee should address, the Treasury should address. This bill cannot do it. It does not take away the importance of that bill, but that is a major problem.

Mr. MARTIN. You recall, of course, that one of the major features of the 1981 tax bill, and one which still seems to have some controversy about it, was the adoption of indexing of tax brackets, which has the effect of neutralizing that inflationary effect of locking people into higher and higher tax brackets year after year.

I gather from what you are saying that you would agree that if we repeal indexing and go back to bracket creep as before, then we are going to increase further this noncompliance problem because median income and upper and lower income people will be moved steadily into higher and higher tax brackets.

Mr. **Chapoton**. Yes, sir, I agree, that exacerbates this problem without question.

Mr. **Martin**. I would appreciate, Mr. Chairman, if the Secretary could have prepared for us an estimate of how long it will take to get median-income taxpayers up to the 50-percent tax bracket, the one that used to be reserved for the richest 20 percent of our taxpayers, if we were to return to bracket creep. Based on forecast inflation rates and based on the effect that bracket creep would have if wages keep pace with inflation, what would be the effect of bracket creep, of moving median income, the middle of that great bell-shaped curve of distribution of incomes, up to the 50-percent bracket?

I think it would be very instructive to the Congress and would help to defuse some of the proposals that we keep hearing for reversing our position on indexing .

Mr. **Chapoton**. We would be happy to supply that, Mr. Martin.

Mr. **Martin**. Thank you very much.

[The following was subsequently received:]

Under 1984 law, a family of four would have to earn about $212,000 to be subject to the top rate of 50 percent. Using the administration's economic scenarios through 1987, assuming a 6 percent annual increase in median income thereafter, and assuming no indexing of the tax system, the median income family would reach the 50 percent tax bracket in about 35 years.

Mr. **Pickle**. Mr. Chairman, before the panel leaves, I would like to commend Mr. Egger for action apparently just taken. To show that these hearings are timely, I noticed in the Washington Post this morning—Mr. Duncan has just given me this notice—that the IRS issued the Revenue Ruling 82–74 concerning the taxpayer who paid someone to burn down his building, after which he took a tax saving capital gain and deducted the arsonist's fee as a business expense. And you ruled against it, so I commend you.

Chairman **Rostenkowski**. If there are no further questions, thank you, gentlemen for joining us today.

The Chair welcomes to the committee Mr. William Anderson of the General Accounting Office. If you care to summarize your statement, without objection, your entire statement will be included in the record. If you will identify your associates, you may proceed with your testimony.

STATEMENT OF WILLIAM J. ANDERSON, DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY DANIEL C. HARRIS AND JOHN B. GUNNER, GROUP DIRECTORS, TAX ADMINISTRATION

Mr. **Anderson**. Thank you, Mr. Chairman.

To my left is Dan Harris and to my right is John Gunner. Both of these gentlemen are group directors at GAO's IRS audit site.

I have written out some notes that basically summarize the thrust of our full statement today and I will read it if I may. I would like to start off by saying that we strongly support the objectives of H.R. 6300, the Tax Compliance Act of 1982. Our position is based on the urgent need for IRS to cope more effectively with the problem of decreasing compliance by the American public.

I spoke to this same issue twice in recent months, once before the Subcommittee on Commerce, Consumer and Monetary Affairs of the Government Operations Committee during hearings involving the adequacy of IRS resources, and again before Senator Dole and Chairman Grassley regarding S. 2198. We pointed out in our testimony that the most disturbing trend in tax administration today is the increasing unwillingness of taxpayers to be honest in their self-assessments of amounts due the Government.

IRS taxpayer compliance measurement program provides insights into the situation. It shows if you track back over time there has been a steady downward trend in the compliance of taxpayers. For example, in 1965 overall compliance for individuals was about 94.3 percent. In 1976 it had gone down to 92.3 percent. If that 92.3-percent compliance rate held in 1980, IRS should have collected about $311 billion from individuals rather than the $287 billion it did collect, a shortfall of about $24 billion.

Further, we now know that TCMP greatly understates the tax gap. For example, using another approach IRS now estimates that individuals underpaid about $83 billion in 1981, rather than the TCMP-indicated $25 billion.

Of special significance is that the new study shows that about $66 billion or about 80 percent of the shortfall was caused by underreported income. That leads me to the reasons we are so supportive of H.R. 6300. One of its primary thrusts is aimed at improving IRS' ability to detect underreporting. It does this in several ways.

First, it would expand the scope of information reporting by closing certain gaps in existing coverage: interest on bearer bonds and other debt instruments, broker transactions, payments to nonemployees, State and local tax refunds, and casualty loss reimbursements.

Second, it would improve the quality of information reporting by strengthening the penalty provisions for unsatisfactory compliance.

And third, it would authorize the Secretary to compel reporting on magnetic media where this is possible and feasible.

I will now briefly speak to the other provisions of H.R. 6300 where our past work provides a basis for comment. First, with respect to title I, we support the objectives of all four parts. Thus, regarding jeopardy and termination assessments, I have testified on a number of occasions about the difficulties encountered by the Federal Government in striking to the ill-gotten gains of organized crime figures and major narcotics dealers under other legislation, such as the Racketeer Influenced and Corrupt Organization Act, the continuing criminal enterprise statute, and various civil forfeiture provisions. Another tool in this struggle can only help.

We do have a caveat in our full statement about the need to assure that IRS and the law enforcement agencies understand how this new authority fits in with the other laws aimed at getting at criminal assets.

Next, we agree with the need to strengthen the currency reporting requirements, the Bank Secrecy Act, to avoid ludicrous situations experienced in the past. I will not bother citing the examples. You are aware of them.

We also agree with the thrust of part 2, concerning abusive tax shelters. IRS' growing inventory of tax shelter cases points out the need to more effectively strike at these schemes at inception by reaching their organizers, rather than expending considerable effort pursuing the customers.

Here again, we have a caveat concerning the need to insure that the lines between proper and improper tax shelter activities are sufficiently clearly drawn to avoid harming legitimate enterprises.

Regarding part 3, here also we concur in the desirability of the thrust of the changes proposed in H.R. 6300. Losers, in former Commissioner Kurtz' phrase, in the audit lottery—that is the first time I had heard it—should have to pay a price for losing. We do believe, however, that the people we are trying to reach could be more restrictively described in the bill.

For example, perhaps we should zero in on people who are parties to these fraudulent activities for their own personal gain, either because they participate for a fee or stand to personally gain from the fraudulent understatement of tax liabilities.

Part 4, on administrative summons, also has our support. I have testified on a number of occasions about the need to make these provisions more like those in the Right to Financial Privacy Act of 1978, where, as in H.R. 6300, the onus would be on the taxpayer to begin a court proceeding to quash the summons. IRS studies have shown convincingly that the present provisions are subject to considerable abuse by taxpayers who too often use them merely as a device to delay and complicate IRS's administration of the tax laws.

Let me now jump to title IV, which would provide IRS better compliance tools to deal with foreign transactions. To me, the steady growth of U.S.-owned assets in tax haven countries illustrates forcefully the need for such legislation.

IRS's recent tax haven report contains some figures that struck me as especially significant. Specifically, between 1968 and 1976, an 8-year period, the assets of U.S. corporations in tax havens grew fivefold, from about $11.7 billion to $55.4 billion.

If the committee sees fit, H.R. 6300 could also serve to correct a problem we noted in a recent study of IRS's administration of section 482 of the code, concerning interentity transactions of multinationals. Specifically, there is a need to provide for the same type of information reporting regarding U.S. subsidiaries of foreign parents as is now required for the foreign subsidiaries of U.S. parents. IRS agrees with us in this matter.

Next, regarding title V, we are in agreement with the need to change the computation of interest provisions. We have issued a report on this subject. We would suggest that, rather than compounding daily, that compounding could be done semiannually and make things easier for the taxpayer.

IRS can program its computers to do either. I think that those out in the private sector who have to deal with the interest provisions might find it easier to cope with the semiannual as opposed to daily compounding.

Regarding partnership returns, title VI, IRS faces certain administrative problems with respect to partnerships that it does not face when dealing with individuals and corporations. Because partnerships are not taxable entities, IRS must deal separately with each partner in computing taxes due the Government and in settling tax disputes. As a result, legitimate partnerships with complex structures present a formidable administrative burden to IRS.

Additionally, the partnership form of business has also become an attractive vehicle for promoters who market tax avoidance schemes with questionable economic value, thereby aggravating IRS' administrative problems. I should note in this regard that apparently there are about 6,000 partnerships that IRS is aware of with over 50 partners, including over 1,000 partnerships with over 500 partners each. So the thrust of this legislation has merit.

Our limited work in the area of partnerships, tax shelters and the windfall profit tax suggests there is a need to revise the tax laws relating to partnerships.

I have more to say, but I will stop there on partnerships, sir, except that we do view it as a problem and do consider that the legislation is well-founded. There obviously is another set of views as to the burdens this will impose and the equity, perhaps, afforded the individual partners in these extremely large partnerships. And we do caution the committee in our full statement to hear, as I know you intend to do, the full set of views on it.

I will close on the Paperwork Reduction Act exemption. This involves another governmental activity that is under my own jurisdiction, specifically the Office of Information and Regulatory Affairs at OMB. GAO stood very firmly behind the Paperwork Reduction Act when it was initially conceived and passed. We do share Mr. Chapoton's views and the administration's views that IRS should continue to be subject to its provisions, at least until such time as some harmful effect can be demonstrated.

Perhaps the time when you would have to start reducing the effectiveness of IRS activities, if you really wanted to achieve that statutory goal of a 25-percent reduction in paperwork, if that ever came to pass then I think it would be time to sit back and reconsider if IRS should be subject to the Paperwork Reduction Act.

I will close on that note, sir, and we will try to answer the questions you may have.

[The prepared statement and attachment follow:]

STATEMENT OF WILLIAM J. ANDERSON

Mr. Chairman and Members of the Committee: We are pleased to be here to assist the committee in its deliberations on H.R. 6300, the Tax Compliance Act of 1982. Our testimony is based primarily on experience we have gained from conducting evaluations of tax administration operations and activities.

During the past 3 years, we have issued numerous reports and given testimony before various congressional subcommittees, including the Ways and Means Oversight Subcommittee, on the income tax noncompliance problem. Currently, we are conducting reviews of various Internal Revenue Service (IRS) programs which deal with the unreported income problem. The appendix to my statement lists various reports we have issued and testimonies we have given since July 1979. It also lists reviews currently in process which relate to the income tax noncompliance problem.

Mr. Chairman, we endorse the overall objectives of H.R. 6300 because it seeks, through a series of measures, to reduce the shortfall in Federal tax revenues attributable to noncompliance with the tax laws and also seeks to enhance the fairness and credibility of our Nation's tax system. Further, the bill addresses several issues and concerns we have surfaced in our tax administration reviews and contains some solutions we have proposed and/or endorsed in the past.

On March 22, 1982, we testified before the Subcommittee on Oversight of the Internal Revenue Service, Senate Committee on Finance, on Senate Bill 2198. (A companion bill—H.R. 5829—has been introduced in the House). At that time, we emphasized the importance of a healthy tax system to the financial stability and welfare of our country. We supported S. 2198's overall objectives of reducing the unreported income problem and enhancing the credibility of our tax system. We also pointed out the need for the Congress to assure that IRS' resources and capabilities keep pace with its increasing workload. (With your permission, Mr. Chairman, I would like to submit a copy of our formal statement on S. 2198 for the record).

Like the Senate bill, H.R. 6300 seeks to substantially improve and expand information reporting; establish a withholding system for pension payments; and revise the rules governing interest payments related to certain tax overpayments and underpayments.

However, H.R. 6300 goes further than S. 2198 in that it seeks to strengthen IRS' ability to collect taxes on income derived from illegal activities and foreign sources. In addition, it seeks to revise certain administrative and judicial proceedings with respect to partnerships and Subchapter S corporations.

We agree that improvements in these broad areas are needed if IRS is to deal effectively with the decline in voluntary compliance. On the other hand, we also have some concerns over certain aspects of the bill. At this point, therefore, I would like to focus on certain sections of the bill and later comment on IRS' need for resources to implement H.R. 6300 should it be enacted into law.

TITLE I—STRONGER TOOLS FOR DEALING WITH ILLEGAL ACTIVITIES, ABUSIVE TAX SHELTERS, AND CERTAIN TAX PROTESTERS

Title I of H.R. 6300 contains several provisions designed to enable IRS to deal more effectively with illegal activities, abusive tax shelters, and certain tax protesters. It also would enhance IRS' ability to carry out criminal and civil tax investigations by alleviating problems IRS has experienced with the third-party recordkeeper summons provisions of the 1976 Tax Reform Act. However, IRS may experience some difficulties in seeking to administer portions of Title I, as currently drafted.

Part I would improve IRS' ability to detect, assess, and collect taxes on cash and cash-equivalent transactions

Part I of Title I should improve IRS' ability to detect, assess, and collect taxes on cash and cash-equivalent transactions. This would be accomplished by strengthening the laws relating to jeopardy and termination assessments and by strengthening a present currency reporting requirement.

Jeopardy and termination assessments

In December 1979, in testimony before the Permanent Subcommittee on Investigations, Senate Committee on Governmental Affairs, we pointed out that IRS had all but abandoned use of jeopardy and termination assessments as civil enforcement tools. H.R. 6300 seeks to promote the use of these important compliance tools through revisions to the laws governing them. Current law effectively restricts IRS from immediately assessing and collecting taxes on cash unless the taxpayers can be identified. H.R. 6300 provides IRS, in two defined instances, the tools necessary to immediately assess and collect taxes due the Government. To prevent potential abuses and to avoid potential jurisdictional problems, the committee may want to make some revisions to one of its two proposals in this area.

H.R. 6300 would authorize the Secretary of the Treasury to impose an immediate assessment and collection on the person possessing, recently possessing, or depositing cash if the Secretary believes that the cash was derived from an illegal activity. The bill defines illegal activity as any violation of Federal, State, or local law punishable by imprisonment. While we believe this proposed addition to the law would enhance the Service's collection efforts, we have two concerns.

First, the bill does not indicate how IRS should determine whether an individual is involved in illegal activities. In the early and mid-1970s, IRS initiated a program directed at narcotics traffickers. Under that program, IRS abused its jeopardy and termination powers in the process.

Many individuals suspected of being involved in illegal narcotics trafficking were assessed taxes via jeopardy or termination action, despite a lack of evidence that taxes were in fact in jeopardy. Moreover, IRS agents often grossly overestimated the amount of taxes due and frequently had initial assessments reduced substantially by subsequent IRS reviews. For example, in a July 1976 report (GGD-76-14), we reported on 40 narcotics-related termination assessments which we had analyzed in detail.

The original assessments in these cases totaled more than $1.2 million while the final assessments were reduced to about $342,000.

In 1976, in response to those abuses, the Congress amended the laws related to jeopardy and termination assessments to better protect taxpayers. To avoid the potential for a recurrence of abuses, the committee may wish to specify with greater descriptive clarity the criteria on which IRS may base its belief that an individual is involved in illegal activities before invoking this provisions.

Second, we would also recommend that the committee specifically address the relationship between this provision and civil and criminal forfeiture statutes, such as those contained in the Racketeer Influenced and Corrupt Organization Act (18 U.S.C. 1961-1964). This may be necessary because where cash and certain illegal activities are involved, the Justice Department and IRS could have competing interests and this could lead to jurisdictional disputes. Such disputes could be avoided by specifying which statutes take precedence and how the proposed statute is intended to operate when all the cash is subject to forfeiture.

Currency reporting requirement

Besides enhancing the utility of jeopardy and termination assessments, H.R. 6300 also would strengthen the current reporting requirement associated with transporting large amounts of cash out of the country. We support the intent of this provision of the bill because it would revise a reporting requirement which currently is difficult to enforce. There is, however, a need for more specific guidance on how this provision is to be interpreted.

The Bank Secrecy Act of 1970 requires anyone who leaves the United States with more than $5,000 in cash or cash equivalents to file a report with the U.S. Customs Service. One objective of this law is to provide Federal law enforcement investigators with a "paper trail" through which to trace the flow of large amounts of cash used in criminal activities. A single failure to report is punishable by a civil penalty limited to the amount of money transported or by criminal penalties consisting of a fine of not more than $500,000 and up to 5 years imprisonment. However, Federal officials have experienced difficulty in enforcing this reporting requirement because some courts have ruled that a crime is not committed until the nonreporter actually leaves the country, at which point apprehension of the violator may no longer be possible.

H.R. 6300 is designed to alleviate this problem by amending the law to state that an attempt to transport shall be subject to the same reporting requirements, and subject to the same penalties, as apply to the act of transporting. Enactment of this provision would clearly signal that the act of tranporting currency out of the country need not be completed for the filing requirement to be violated. We endorse this signal. However, we believe that further guidance is necessary on what constitutes an attempt to leave the country. For example, has an attempt been made when an individual (1) purchases an airline ticket, (2) enters the boarding area with an airline ticket, or (3) boards a plane which is leaving the country? Definitive guidance in this regard is needed.

Part II would enhance IRS' ability to deal with abusive tax shelters

For several years now, IRS has focused much attention on abusive tax shelters. Of necessity, IRS' approach has centered on the examination process and ensuing litigation. Part II of Title I would provide IRS with new ways of dealing with abusive shelters at the front end of the process, that is, before investors purchase certain shelters and begin filing tax returns which require examination and often lead to litigation. Used effectively, these new compliance tools could greatly assist IRS in dealing with the problem of abusive tax shelters. On the other hand, administering these provisions may present IRS with some problems.

Among other things, the bill would authorize IRS to assess a new penalty against those promoting or selling abusive tax shelters. In addition, it would authorize IRS to seek an injunction against such persons.

These new compliance tools could enable IRS to prevent the marketing and sale of abusive shelters. This would reduce or eliminate the need for IRS to deal with the large number of taxpayers' participation in such shelters.

Effective use of these tools could significantly slow the rate of growth of IRS' tax shelter case inventory, now reported to be 255,000 returns in the Examination Division. This decrease should enable IRS to reduce the percentage of direct examination time now being spent on tax shelters—about 9 percent—thereby freeing these resources for other compliance-related activities. The decreasing inventory of tax shelter cases should also reduce the burden on the Tax Court, which currently has a backlog of about 11,900 tax shelter cases. Equally important, these provisions could help protect taxpayers from unscrupulous promoters.

While we agree that a legislative initiative in this area is needed, we do have some concerns whether the reach of this provision is unduly broad. In this regard, it should be recognized that IRS does not presently have a sufficiently clear definition of what consititutes an abusive tax shelter. Given this, we recommend that the legislation itself provide or require the establishment of clear definitions and criteria to assure that IRS' use of these provisions will affect only the truly abusive shelters.

Also, to assure that the Federal Government is taking a coordinated approach, the committee may wish to require close liaison between IRS and the Securities and Exchange Commission when federally registered promotions are involved. Finally, to assure adequate oversight of the implementation of these provisions, the committee may also wish to require that IRS develop summary information on its use of the penalty and the injunction.

Part III would authorize additional penalties to deter certain forms of tax noncompliance

Part III ot Title I would authorize IRS to assess a greater fraud penalty than allowed under current law. It also provides for new penalties directed at (1) individuals who aid or advise taxpayers in violating the tax laws and (2) tax protesters. We understand and endorse the committee's goals in these areas. However, some of the new penalties should be written in a more specific manner. Otherwise, they may not achieve the committee's intent or may even have some unintended effects.

Section 121 of H.R. 6300 increases the fraud penalty by adding a percentage of the tax understatement to the present fraud penalty. This increased fraud penalty could provide an added deterrent against fraud and we therefore support its enactment.

Section 122 provides for a new civil penalty to be applied against persons who aid in, assist in, procure, or advise in the preparation or presentation of a return, affidavit, claim, or other document which they know will lead to an understatement of tax liability under the Internal Revenue laws. We believe that this proposed penalty covers too broad a target population. We think that the penalty would be more appropriate if applied to those holding themselves out as knowledgeable of the tax law and providing aid, advice, or assistance on that basis. This could narrow the target population so that administration of this probability of success in its application.

The penalty provisions of the bill should also help IRS in its efforts to deter illegal tax protesters. In July 1981, we reported that the protest movement was a growing threat to the Nation's tax system, particularly because of the visibility of protest leaders and activists, and their "sales" approach, which tends to attract followers (GGD-81-83, July 8, 1981). The number of protester returns filed has increased about 283 percent since 1978, from about 7,100 to 27,000 in 1981. Many of these returns do not contain sufficient information from which the substantial correctness of the tax shown can be judged (such as constitutional protest scheme returns); others contain information indicating that the amount of tax being paid is substantially incorrect (such as war protest returns which contain unauthorized subtractions from computed tax liabilities).

The $500 penalty assessment provided for in section 123 of H.R. 6300 should, if judiciously applied, help in deterring at least the average protester from filing such returns. Also, the provisions in section 112 of H.R. 6300 aimed at penalizing and enjoining promoters of abusive tax shelters, might be effective against some protest schemes, such as the family estate trust—one of the most popular schemes at the time of our review. Likewise, the penalty provisions contained in section 122 might also help IRS deter some illegal tax protesters.

In sum, the bill's proposed revisions to the penalty provisions of the Internal revenue Code could, if modified in certain ways, help IRS deal with some key compliance problems.

Part IV's revised rules governing third-party recordkeeper summonses would facilitate criminal and civil tax investigations

In various reports and testimonies over the past several years, we have pointed out that the summons provisions of the 1976 Tax Reform Act were having an unintended effect. Specifically, we have found that some taxpayers have used the provisions solely as a means for delaying or impeding IRS investigations. Part IV of Title I seeks to partially remedy that problem while preserving essential taxpayer rights. We strongly endorse enactment of this part of H.R. 6300.

In testimony before the House Ways and Means Oversight Subcommittee on April 26, 1982, we specified the reasons why we believe there is a need for a legislative change to the third-party recordkeeper summons provisions. We will not reiterate that testimony here. However, one recent development has further underscored the need for legislation. On May 4, 1982, IRS provided us with an analysis of third-party summonses it issued during fiscal years 1980 and 1981. Although we have had insufficient time to check the accuracy of IRS' figures, the overall analysis verifies the accuracy of our previous findings. Specifically, IRS found that protesters and individuals involved in illegal activities were primary users of the summons safeguard provisions. IRS also found that these individuals frequently used the safeguards solely to delay investigations. That is, they often stayed compliance with summonses but failed to appear in court for hearings. On the other hand, IRS verified that the law has, in some instances, afforded taxpayers protection from improper summonses.

H.R. 6300 seeks to strike a better balance between IRS' information needs and taxpayer rights. The bill retains all the basic safeguards set forth in current law. However, it also seeks to limit taxpayers' ability to use those safeguards solely to delay IRS investigations. This is accomplished by requiring that the taxpayer initiate a court action to stay compliance with a third-party summons. Thus, the committee's approach would have the effect of curbing an abuse while also fully retaining essential taxpayer safeguards.

TITLE II—IMPROVED INFORMATION REPORTING IS WARRANTED

Title II of H.R. 6300 seeks to improved information reporting by having more income covered by such reporting and providing stiff penalties and other measures to assure that payers submit usable reports. It also would exempt IRS from certain requirements of the Paperwork Reduction Act of 1980. These provisions are somewhat similar to those contained in S. 2198.

We recognize and have previously supported the need for improved information reporting to help deal with the so-called subterranean economy. IRS' studies show that—next to tax withholding—information reporting represents the single most effective tool for promoting taxpayer compliance in reporting legally earned income. Thus, we support cost-effective information reporting and follow-on computer matching programs. We do, however, have one suggestion for your consideration with respect to information reporting. Also, we are opposed at this time to exempting IRS from the Paperwork Reduction Act of 1980.

We have reported and given congressional testimony several times during the last 3 years on the need for enhanced information reporting. Part I of Title II would improve the use of information reporting as a deterrent to tax cheating by increasing or clarifying the types of income covered; increasing the penalties for payers who fail to file required information returns with IRS or payees; increasing the penalties and, in certain instances, requiring tax withholding when payers of payees fail to provide the identification numbers IRS needs to match information returns with tax returns: and requiring IRS to prescribe standards for filing information returns on magnetic tape or in other machine-readable form.

We generally support these provisions. However, H.R. 6300 contains no provision for a minimum penalty if a refund return is not filed in a timely manner.[1]

In our report on tax return nonfilers (GGD-79-69, July 11, 1979), we recommended that the Congress consider the matter of imposing a penalty on nonfilers due refunds, and we proposed various alternatives for imposing such a penalty. Our recommendation for a minimum penalty on nonfilers due refunds was based upon two principal factors. First, it was needed to encourage such persons to comply with the filing date requirments and to assure equitable treatment of taxpayers. Second, we were concerned about the costs IRS incurs in identifying and investigating nonfilers, many of whom are subsequently found to be due refunds. We, therefore, suggest that the committee consider adding to its bill a provision authorizing IRS to impose a penalty on nonfilers due refunds. Such a provision is contained in S. 2198.

Now, Mr. Chairman, I would like to discuss the proposal to exempt IRS from the requirements of the Paperwork Reduction Act of 1980.

The Paperwork Reduction Act of 1980 requires that information collection requests must be referred to the Office of Management and Budget (OMB) for approval. Section 215 of Title II of H.R. 6300, like S. 2198, would exempt IRS from this requirement. We do not believe that sufficient evidence is presently available to support the need for this exemption.

The Paperwork Reduction Act grew out of a recognition by the Congress and the Executive Branch that the Federal Government runs principally on vast quantities of information which it collects from the public. For example, according to OMB's most recent figures, the Government will impose some 1.3 billion hours of paperwork burden on the public during fiscal year 1982. The act was designed to provide a policy-making framework and an organizational and management structure to improve the management of all the resources employed in collecting, processing, using, disseminating, storing, and disposing of information. In this regard, it addresses a wide range of other information management issues, such as promoting the improved application of computers, telecommunications, and other information technologies.

---

[1] We discuss this matter here because the Joint Committee on Taxation, in its comparative analysis of H.R. 6300 and H.R. 5829 (S. 2198), pointed out in its discussion of "Provisions to Improve Reporting Generally" that H.R. 5829 contained a minimum penalty for extended failure to file a tax return.

We strongly supported enactment of the Paperwork Reduction Act, recognizing that it would eliminate IRS' exemption from the reports clearance requirements of the Federal Reports Act of 1942, the predecessor to the Paperwork Reduction Act. Our position was based on the belief that an effective mechanism for eliminating unnecessary paperwork burdens on the public and reducing Federal information collection and processing costs required that all agencies be included in the clearance process required by the act. Also, IRS imposes nearly half the private sector's burden of reporting to the Federal Government.

At the time and since the act was enacted, several arguments were and continue to be made for exempting IRS from the Paperwork Reduction Act's provisions. These arguments include: (1) OMB's lack of tax expertise, (2) delays in the collection of tax revenues, and (3) the detrimental impact of the paperwork reduction goals on IRS' collection of the information necessary for administering the tax laws.

To us, the most compelling reason for exempting IRS from the Paperwork Reduction Act's requirements would be evidence that the act is impacting adversely on the collection of revenues. Presently, we know of no such evidence. We believe that unless and until such evidence is available, the act's requirements should continue to apply to IRS.

TITLE IV—BETTER COMPLIANCE TOOLS TO DEAL WITH FOREIGN TRANSACTIONS

Title IV of the proposed legislation contains provisions which address certain information gathering and administrative problem areas in the taxing of international transactions. The use of international transactions by individuals and businesses to avoid and evade U.S. taxes has long been a concern to the Congress and to IRS. Although both the Congress and IRS have sought to limit such transactions, noncompliance continues to grow. Especially troubling to IRS is the increase in the use of offshore tax havens to avoid or evade U.S. taxes. Hopefully, the provisions under title IV will improve IRS' ability to gather information concerning international transactions in general and tax haven transactions in particular.

In January 1981, IRS issued a report based on an extensive review of tax havens. The report, entitled "Tax Havens and Their Use by United States Taxpayers—An Overview," included various administrative, legislative, and tax treaty recommendations designed to prevent serious abuse of the U.S. tax system. Some of these proposed recommendations are contained in Title IV of H.R. 6300.

Section 401 of H.R. 6300 would establish venue for purposes of summons enforcement in the U.S. District Court for the District of Columbia in those situations where a U.S. citizen or resident living abroad is summoned by IRS. Currently, an administrative summons directed to such a person outside the U.S. may prove unenforceable. This is because the law requires that the person reside in or be temporarily located in a U.S. judicial district before a court of that district can enforce the summons. We agree with the intent of section 401. It should enhance IRS' access to books and records in cases where the documents are under the custody or control of an entity or person who resides in a foreign country.

Section 402 contains various provisions concerning burden of proof and the admissibility in court of documentation maintained outside the U.S. Under present law, the burden of proof in tax matters is generally on the taxpayer. Nevertheless, IRS has experienced problems in dealing with international transactions. In some cases, taxpayers have refused to furnish documents, have used delaying tactics, or have not produced the information until they are in court. In the latter instance, IRS has insufficient time to evaluate the information.

Under section 402, a taxpayer who has refused to provide documentation of foreign transactions requested by IRS during audit would generally be restricted from using the information in court. Exceptions would be made if the taxpayer could prove to the court that the requested documentation was not provided due to reasonable cause.

While we generally agree with the burden of proof and admissibility of evidence provisions contained in section 402, we are concerned with this section because it specifically excludes foreign nondisclosure laws as reasonable cause for a taxpayer not producing documents requested by IRS. This exclusion forces a taxpayer to choose between violating a U.S. law or violating a foreign law. Given this, the committee may wish to further consider the implications of this provision for affected taxpayers.

IRS officials have complained about inadequate reporting of transactions involving controlled foreign corporations. In this regard, section 411 would add another penalty for failure to furnish information required of controlled foreign corporations. The penalty would be $1,000 for each failure to furnish information for an accounting period, with additional $1,000 penalties for each 30-day period during which the information is not produced. We agree with this provision and believe that it will increase the information available to IRS concerning controlled foreign corporations, particularly those operating in tax haven jurisdictions.

However, we think the provision should go further. As presently drafted, it does not require that similar information be provided to IRS by foreign-controlled U.S. corporations. Foreign-controlled U.S. subsidiaries conduct the same type of transactions with their foreign parents as do controlled foreign subsidiaries with their U.S. parents. Nevertheless, existing provisions require that information returns be filed only by U.S. parent corporations for their foreign subsidiaries.

IRS' international tax examiners consider the data contained on these information returns to be important in identifying potential tax adjustments and in planning their examination work. IRS officials informed us that the need for similar information on foreign-controlled U.S. corporations is becoming increasingly important because of the significant increase in the number and assets of foreign-controlled U.S. corporations. Between 1959 and 1974, the number of foreign-controlled U.S. corporations increased from 1,006 to 6,538 while the assets of such corporations grew from $8.4 billion to more than $75 billion.

In a previous report concerning IRS's determination of income of multinational corporations (GGD-81-81, September 30, 1981), we recommended that information returns be required of U.S. subsidiaries controlled by foreign parent corporations. We still believe that obtaining information from such entities would prove valuable to IRS. Consequently, we suggest that our recommendation to require information returns from foreign-controlled U.S. corporations be considered for inclusion in section 411 of the bill.

TITLE V—MODIFICATIONS TO RULES FOR CALCULATING INTEREST ARE WARRANTED

Title V of H.R. 6300 makes several revisions relating to interest rate computations and assessments. In general, the revisions make sense from both a policy standpoint and a good business practice standpoint. However, the committee may want to modify the provisions in several respects.

First, H.R. 6300 does not provide for a semiannual determination of the interest rate to be paid on underpayments, on overpayments, and for other purposes. S. 2198 and our previous report (GGD-81-20, October 16, 1980) call for a semiannual determination because of the volatile movement in interest rates. For example, in our report, we noted that in fiscal year 1979 an additional $119 million could have been assessed in interest charges on delinquent taxes if such a provision had been in effect. A semiannual adjustment in interest rates would be both fairer and more equitable than the present annual determination. We, therefore, suggest that the committee consider the more frequent semiannual adjustment of the interest rate.

Second, Section 501 of H.R. 6300 provides for daily compounding of interest. Although daily compounding of interest may be feasible, it may not be desirable. Clearly, IRS can program its computers to make daily compounding computations. On the other hand, it is not so easy for human beings to make the same computations. Quite frequently, for example, IRS revenue officers make delinquent tax computations in the field. This requires a manual interest rate computation. Also, possibly to avoid the recent higher interest rate, more taxpayers who calculate or are assessed taxes after the due date of a return may be paying taxes due before receiving a bill from IRS. In so doing, taxpayers must make a manual interest rate calculation. In addition, many taxpayers may wish to calculate interest assessments for other reasons, such as verifying IRS' computations. If H.R. 6300 is passed in its present form, these individuals would have to make interest computations using a daily compounding formula. Without a special calculator or a knowledge of the mathematics of finance, this would be a very difficult task.

Moreover, the effective interest rate difference between daily and a less frequent compounding period, for example, quarterly or, as recommended by S. 2198, semiannually, is not that great. At the current nominal interest rate of 20 percent, for example, daily compounding yields an effective annual interest rate of 22.13 percent.

Semiannual compounding would yield a 21 percent rate annually, quarterly compounding would yield 21.55 percent, and monthly compounding would yield 21.94 percent. Thus, the committee may want to consider whether daily compounding is warranted in light of the complexities associated with the process and its marginal yield when compared to a less frequent compounding period.

Third, besides providing for compounding of interest, Section 502(a) of H.R. 6300 would extend the grace period allotted to IRS to process late-filed refund returns. In our report on tax return nonfilers (GGD-79-69, July 11, 1979), we noted that interest was being paid to individuals or corporations filing their returns after the required due date. Under present law, interest accumulates from the due date of the return if the late return is not processed within 45 days after receipt by IRS. S. 2198 would make interest payable from the date the return is filed and would retain the 45-day processing period. H.R. 6300 would make interest payable from the due date of the return but would change the grace period for processing late-filed returns to 90 days.

For several reasons, we agree that the return processing grace period for late-filed returns should be extended to 90 days from the date of filing. Late-filing, for example, generally is not caused by IRS. Further, there is a potentially high cost related to current high interest rates. Also, IRS would face processing problems if late-filed returns were received in April in addition to those current returns being filed.

Concerning the latter point, both S. 2198 and H.R. 6300 provide that no interest will be paid until a return is filed in a form suitable for IRS processing. S.2198 does not provide a definition of a processible form. Section 502(b) of H.R. 6300 specifies that a return in processible form is one that contains certain identification information and can be mathematically verified. We agree with the concept of these provisions and also believe that a definition, such as the one provided in H.R. 6300, is essential to assure effective administration.

TITLE VI—EFFORTS TO EASE THE ADMINISTRATIVE BURDEN ON IRS WITH RESPECT TO PARTNERSHIP TAX RETURNS

IRS faces certain administrative problems with respect to partnerships that it does not face when dealing with individuals and corporations. Because partnerships are not taxable entities, IRS must deal separately with each partner in computing taxes due the Government and in settling tax disputes. As a result, legitimate partnershps with complex structures present a formidable administrative burden to IRS. Additionally, the partnership form of business has also become an attractive vehicle for promoters who market tax avoidance schemes with questionable economic value, thereby aggravating IRS' administrative problems.

Title VI of H.R. 6300 would comprehensively amend the partnership tax laws. The proposed amendments would greatly simplify IRS' task in administering the tax laws as they relate to partnerships, individuals and other entities involved in partnerships, and Subchapter S corporations.

Our limited work in the area of partnerships, tax shelters, and the windfall profit tax suggests that there is a need to revise the tax laws relating to partnerships. In a September 1980 report (GGD-80-98), we commented on IRS' processes for planning audit coverage levels and selecting returns in its partnership program. IRS has since implemented many improvements in that program. However, the number of multi-tiered partnerships and the growth of partnerships in general continue to present a challenge to IRS' resources and capabilities.

For example, at the request of the Joint Committee on Taxation, we analyzed IRS-provided data from partnership returns filed for tax year 1978. Regarding multi-tiered partnerships, we found that 69,091 of the partnerships which filed a return for tax year 1978 indicated that (1) the subject partnership also participated in another partnership and/or (2) one or more of the partners were themselves partnerships. Also, 16,547 partnerships, or over 23 percent of the 70,913 partnerships reporting a loss of more than $25,000, were involved in tiering. Partnerships reporting large losses, according to IRS, are the ones most likely to be tax shelters.

The partnership form of organization is growing in popularity. For example, the number of partnership returns filed has grown from 992,000 in 1972 to 1,362,000 in 1980. The greatest percentage increase has been in the number of partnerships with more than 500 partners each. From 1972 to 1979, that segment increased by more than 232 percent—from 309 in 1972 to 1,027 for tax year 1979 (the last year for which figures are available).

Clearly, something must be done to reduce the administrative burden on IRS while also preserving and protecting taxpayers' rights. Title VI makes a good faith effort in this respect. However, some of those who will be most affected by Title VI have expressed concerns over certain provisions. Those concerns need to be further considered before legislation is enacted.

In sum, Mr. Chairman, we support the objectives of your bill. We have provided some suggestions and cautions for your consideration. We think they will enhance the effectiveness of H.R. 6300 in achieving greater compliance with the tax laws.

In closing, we would like to alert you to one other area of concern, that being the need for additional IRS resources to effectively implement your proposals. For some time, we have been advocating increases in IRS resources. In this regard, IRS will need, at least on a temporary basis, some additional people and computer resources to implement this bill effectively. Such short-term additional expenditures could yield extensive long-term benefits. We, therefore, suggest that the committee do what it can to ensure that IRS gets the resources it needs to effectively administer this bill should it be enacted into law.

Mr. Chairman, this concludes my prepared statement. We would be pleased to respond to any questions.

[Appendix]

GAO REPORTS AND TESTIMONIES ISSUED SINCE JULY 1979 AND ONGOING JOBS RELATED TO THE INCOME TAX COMPLIANCE PROBLEM

REPORTS

July 11, 1979.—GGD-79-69: Who's Not Filing Income Tax Returns? IRS Needs Better Ways To Find Them And Collect Their Taxes.

August 3, 1979.—GGD-79-43: IRS Can Improve Its Process For Deciding Which Corporate Returns To Audit.

August 15, 1979.—GGD-79-59: IRS' Audits of Individual Taxpayers And Its Audit Quality Control System Need To Be Better.

November 6, 1979.—GGD-80-9: Improved Planning For Development And Selecting IRS Criminal Tax Cases Can Strengthen Enforcement of Federal Tax Laws.

January 24, 1980.—GGD-80-33: IRS Computer Assisted Audit Program.

February 11, 1980.—GGD-80-34: IRS Efforts To Detect And Pursue Corporate Nonfilers.

September 5, 1980.—GGD-80-98: IRS Needs To Reconsider Its Examination Strategy For Certain Partners.

October 16, 1980.—GGD-81-20: New Formula Needed To Calculate Interest Rate On Unpaid Taxes.

October 20, 1980.—FGMSD-84-4: IRS Can Expand And Improve Computer Processing Of Information Returns.

April 29, 1981.—GGD-81-25: Streamlining Legal Review Of Criminal Tax Cases Would Strengthen Enforcement Of Federal Tax Laws.

May 12, 1981.—GGD-81-66: Observations Concerning The Internal Revenue Service's Management Of Criminal Tax Cases.

July 8, 1981.—GGD-81-83: Illegal Tax Protesters Threaten Tax Systems.

July 23, 1981.—GGD-81-80: Bank Secrecy Act Reporting Requirements Have Not Yet Met Expectations, Suggesting Need For Amendment.

September 30, 1981.—GGD-81-81: IRS Could Better Protect U.S. Tax Interests In Determining The Income Of Multinational Corporations.

November 5, 1981.—GGD-82-4: What IRS Can Do To Collect More Delinquent Taxes.

CONGRESSIONAL TESTIMONIES

July 16, 1979.—Before the House Ways and Means Subcommittee on Oversight on IRS' efforts to identify and pursue income tax nonfilers and underreporters.

July 17, 1979.—Before the House Ways and Means Subcommittee on Select Revenue Measures on compliance problems of independent contractors.

September 6, 1979.—Before the House Government Operations Subcommittee on Commerce, Consumer, and Monetary Affairs on the subterranean economy.

October 11, 1979.—Before the House Ways and Means Subcommittee on Oversight on the efforts of IRS' Criminal Division to detect and deter underreporters.

November 15, 1979.—Before the Joint Economic Committee on the underground economy.

November 29, 1979.—Before the House Banking, Finance, and Urban Affairs Subcommittee on General Oversight and Renegotiation on the use of currency and foreign account reports to detect narcotics traffickers.

December 13, 1979.—Before the Senate Governmental Affairs Permanent Subcommittee on Investigations on IRS' Efforts to Combat Narcotic Traffickers.

September 18, 1980.—Before the House Ways and Means Subcommittee on Oversight on the subject of compliance by Federal Agencies with the requirements to file 1099 information returns.

October 10, 1980.—Before the House Government Operations Subcommittee on Commerce, Consumer, and Monetary Affairs on IRS' document matching program.

October 1, 1980.—Before the House Banking Finance, and Urban Affairs Subcommittee on General Oversight and Renegotiation on Implementation of the Bank Secrecy Act's Reporting Requirements.

May 11, 1981.—Before the House Ways and Means Subcommittee on Oversight on the adequacy of IRS compliance resources for fiscal year 1982.

June 10, 1981.— Before the House Government Operations Subcommittee on Commerce, Consumer, and Monetary Affairs on IRS' efforts against illegal tax protesters.

July 23, 1981.—Before the House Banking Finance, and Urban Affairs Subcommittee on General Oversight and Renegotiation on The Bank Secrecy Act.

March 17, 1982.—Before the House Government Operations Subcommittee on Commerce, Consumer and Monetary Affairs on the adequacy of IRS' resources.

March 22, 1982.—Before the Senate Finance Subcommittee on Oversight of the Internal Revenue Service on The Taxpayer Compliance Improvement Act of 1982.

April 26, 1982.—Before the Senate Finance Subcommittee on Oversight of the Internal Revenue Service on The Independence Contractor Tax Classification and Compliance Act of 1982.

April 26, 1982.—Before the House Ways and Means Subcommittee on Oversight on IRS policies and procedures to safeguard taxpayer rights and the effects of certain provisions of the 1976 Tax Reform Act.

CURRENT REVIEWS

(1) Review of problems IRS encounters in auditing tax shelter schemes
(2) Review of the quality of IRS' corporate tax return audits
(3) Review of IRS' resource management activities
(4) Review of IRS' use of publicity to promote voluntary compliance with the tax laws
(5) Survey of IRS' rewards for information program
(6) Survey of IRS' unreported income program

[Attachment]

STATEMENT ON S. 2198 BEFORE A SUBCOMMITTEE OF THE SENATE FINANCE COMMITTEE, MARCH 22, 1982

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist your Subcommittee in considering the problem of the income tax compliance gap and the need for S.2198, the Taxpayer Compliance Improvement Act of 1982, to help address this problem. Our testimony is based primarily on our overall experience gained from conducting audits of tax administration operations and activities over the past several years.

We first addressed the issue of unreported income in July 1979. At that time, we issued a comprehensive report in which we estimated that about 5 million individuals and couples owing about $2 billion in taxes did not file tax returns for tax year 1972, the year for which the most current data was available for analysis. We also estimated that IRS had only been able to secure delinquent returns from about 12 percent of the estimated 5 million nonfilers. Since July 1979, we have issued numerous reports and provided extensive testimony addressing IRS' tax administration activities and the actions needed to improve IRS' compliance enforcement efforts, particularly against the unreported income problem. We are also presently conducting several reviews of various IRS programs which are directed wholly or partially at addressing the unreported income problem. Appendix I to my statement lists the reports issued and testimonies delivered since July 1979, as well as reviews currently in progress, which relate to the income tax compliance problem.

Mr. Chairman, S.2198 addresses several issues and concerns we have surfaced in our reviews. It also contains some solutions we too have proposed in the past. Thus, while we have not had sufficient time to do an in-depth analysis of the bill's individual provisions, we endorse its overall objectives. It seeks to reduce the shortfall in Federal tax revenues by focusing on noncompliance attributable to some types of unreported income. As you know, unreported income is IRS' most serious compliance problem.

TAXPAYER NONCOMPLIANCE DIRECTLY AFFECTS AVAILABLE FEDERAL REVENUES

The Federal Government's financial well-being depends, in large measure, on whether people are willing and able to support our Nation's tax system. The system, which is based on voluntary compliance, is generally regarded as the most efficient, effective, and fair approach for carrying out the unpopular function of collecting the revenue necessary for national defense and other essential Government activities. The tax system provides over 90 percent of the revenues for financing the Government's programs and activities. In 1981, this amounted to about $600 billion.

To assure that the tax system provides maximum revenue at least cost, IRS must strive to achieve the highest possible degree of voluntary compliance with the tax laws. This is very important because even a slight decrease in compliance levels translates into billions of dollars of foregone tax revenue annually.

Despite the importance of our Nation's tax system, however, it is not in as good health as it should be. There is a trend toward contempt and abuse of the system which seriously undermines the basic concept of voluntary compliance on which the system depends. Extensive evidence is available to show that noncompliance among both corporate and individual taxpayers is a serious problem and is getting worse.

The Subcommittee has already well documented the extent of the voluntary compliance problem. Therefore, we will not belabor the point. The problem is well-recognized and it is now more important to focus attention on what can be done to close the income tax compliance gap and reduce the shortfall in Federal revenues. In this regard, we believe that consideration of S. 2198 is a step in the right direction.

S.2198 SHOULD HELP IRS REDUCE THE COMPLIANCE GAP

S. 2198 seeks, among other things, to limit or reverse the growth of the income tax compliance gap by (1) improving information reporting, and (2) providing for comprehensive revision of the penalty and interest requirements. The sponsors of the bill also recognize the need for increasing the level of IRS' resources. We generally agree that improvements in these broad areas are vital for IRS to effectively deal with the decline in voluntary compliance, especially that aspect involving unreported income.

We previously testified that improvements--similar to those included in the proposed legislation--were needed in information reporting. Such reporting and the follow-on matching program represent a powerful tool for promoting taxpayer reporting of income. IRS has developed data showing that there is a direct correlation between the presence of an information document and the level of compliance. And there is, indeed, potential for (1) expanding the income subject to information reporting and matching, and (2) improving the quality of that reporting already required--principal objectives of the proposed legislation.

The proposed legislation calls for information reporting on (1) interest payments on Federal debt and bearer obligations, (2) charged tips, (3) transactions involving capital gains on securities and commodities, and (4) State tax refunds. In earlier testimonies, we identified interest on the U.S. public debt and State tax refunds as potential candidates for information reporting and the document matching program. We also suggested that for other types of income, such as alimony, surrogate information documents like the 1040 return may already exist. We have not specifically considered tips or capital gains on securities and commodities in our previous work.

The proposed legislation also seeks to improve information reporting through specific measures designed to better insure that IRS can use all of the information documents it gets. Specifically, the bill, among other changes, gives IRS authority to require payers filing large numbers of information documents to file on computer tapes instead of paper and increases the penalty which IRS can assess if documents are submitted without a taxpayer identification number.

We agree with the importance of payers submitting information documents on magnetic media. Such documents are much more likely to be used since it is considerably less costly for IRS to process magnetic media than documents submitted on paper. We testified in 1979 that, at that time, it cost IRS $400 to process 100,000 documents submitted on magnetic tapes as opposed to over $20,000 to process the same number received in paper form. Over the years, IRS has successfully promoted more computer media reporting. Notwithstanding, of 645 million information returns received by IRS in 1980, more than 300 million were submitted on paper. In an October 1980 report (FGMSD-81-4), we recommended that IRS seek ways to further increase the filing of information documents on computer readable media. We also suggested that IRS investigate the use of optical character recognition (OCR) equipment to transcribe nonwage paper information documents and consider sharing equipment with the Social Security Administration. The Social Security Administration uses OCR equipment to process millions of withholding statements (W-2s) submitted by employers.

The penalty provision is also important. IRS cannot compare or match information documents to tax returns without the identification number, and it is costly for IRS to research its own records or to contact payers to get missing numbers. That problem causes millions of documents to now go unused. Increasing the penalty should help, if IRS enforces it. We previously found, however, that IRS generally does not assess penalties on payers who submit documents lacking taxpayer identification numbers. The penalty was seldom assessed because, according to IRS officials, the process was not cost beneficial. Raising the penalty amount should take care of that problem and serve as a greater deterrent.

A second problem we noted during our earlier review, was the lack of any definition or guidance on what constitutes reasonable cause for submitting an information document without an identification number and what evidence payers should provide IRS to show that sufficient effort was made to obtain an identification number. If these questions have not been answered, IRS may continue to make little use of the penalty provision. However, the withholding provisions included in the proposed legislation should help. This is not to say, however, that IRS should stop using other approaches to improve the completeness of the documents it receives. For example, when IRS does find an identification number for an incomplete document, it notifies the payer. It also asks the payer to correct appropriate records and include the identification number on future submissions.

In addition to the need for measures to improve the completeness of information reported, we agree measures are also needed to protect against nonreporters. In this regard, penalties and interest--the second principal component of the proposed legislation--are important tools to promote better information reporting and taxpayer compliance. We previously testified about problems in assuring that payers--including Federal agencies--submit all required information documents. Tough penalties are a necessary part of the effort to promote or enforce such reporting. Higher penalties will no doubt help. Our prior work, however, indicates a more fundamental problem that must also be addressed--IRS needs to do more to identify and pursue noncompliers.

In addition to the penalties associated with information reporting, the bill also proposes other penalties and interest requirements. Section 113 of S. 2198, for example, makes some changes in interest payment computation which we have previously identified as needed and which we support. In our report on tax return nonfilers (GGD-79-69, July 11, 1979), we noted that interest was paid on refunds to nonfilers who filed their return after being caught. IRS had to pay out such interest because it did not process these returns within 45 days after they were filed, as required by law. To avoid having to pay such interest, we recommended that IRS establish a priority system to make sure that delinquent tax returns involving refund claims are processed within 45 days of being filed. It appears that S. 2198 would eliminate this problem by prohibiting the payment of interest on overpayments associated with tax returns filed late. Thus, we support this provision of the bill. Also, in our report on nonfilers we recommended that the Congress consider the matter of imposing a penalty on nonfilers due refunds, and we proposed various alternatives for imposing such a penalty. Thus, we support the proposed legislation's requirement for a new minimum penalty for the extended failure to file any income tax returns.

Section 112 of S. 2198 provides for a semiannual determination of the rate of interest. In a previous report (GGD-81-20, October 16, 1980), we recommended such a semiannual adjustment and reported that in fiscal year 1979 an additional $119 million could have been assessed in interest charges on delinquent taxes if such a provision were enacted. There is no reason to believe that the volatile movement of interest rates experienced in the recent past will not recur; therefore, semiannual adjustment of IRS' interest rate would seem both fair and equitable. We also note that section 111 provides for semiannual compounding of interest. We agree with this provision as a matter of policy and good business.

In announcing S. 2198, the bill's sponsor and co-sponsors indicated that increased IRS resources will also be needed to stem the growth of the noncompliance problem. Specifically, they support the need for increased resources for collection activities as requested in the fiscal year 1983 budget and urge the Administration to increase funding in the budgets for fiscal years 1984 and 1985.

We agree that additional resources are needed to reduce noncompliance with the tax laws. Just 5 days ago before the House Government Operations Subcommittee on Commerce, Consumer and Monetary Affairs, we stated that various factors, including declining voluntary compliance, have contributed to growth of IRS' workload but that IRS' resources have not kept pace. We also pointed out that administrative and legislative actions can be taken which would allow IRS to make more efficient and effective use of its existing resources. In our view, however, such actions alone will not be sufficient. We believe an increase in IRS' resources is needed to maintain the integrity of our tax system and collect the revenues necessary for financing essential

Government activities. Such an increase, within reason, would not increase the Federal budget deficit. This is because IRS' compliance programs, on the average, generate tax revenue in amounts that far exceed the programs' cost. The full text of my statement before the House Subcommittee is attached as appendix II.

- - - -

In conclusion, Mr. Chairman, our work over the past several years supports the fact that declining voluntary compliance with the tax laws is a serious problem. In view of the substantial loss in Federal revenue that is resulting, the Government needs to make a concerted and balanced effort to recover unpaid taxes, particularly those due on unreported income. While we have not yet analyzed the bill in depth, it addresses many issues and concerns we have raised in the past. Overall, it is a step in the right direction, and together with additional resources, should facilitate IRS' enforcement of the tax laws. If you have no objections, Mr. Chairman, we would like to provide the Subcommittee with more specific comments on the bill at a later date.

This concludes my prepared statement. I would be pleased to answer any questions.

GAO Reports and Testimonies Issued Since July 1979 And Ongoing Jobs Related To The Income Tax Compliance Problem

Reports

7/11/79	GGD-79-69: Who's Not Filing Income Tax Returns? IRS Needs Better Ways To Find Them And Collect Their Taxes
8/3/79	GGD-79-43: IRS Can Improve Its Process For Deciding Which Corporate Returns To Audit
8/15/79	GGD-79-59: IRS' Audits Of Individual Taxpayers And Its Audit Quality Control System Need To Be Better
11/6/79	GGD-80-9: Improved Planning For Developing And Selecting IRS Criminal Tax Cases Can Strengthen Enforcement of Federal Tax Laws
1/24/80	GGD-80-33: IRS Computer Assisted Audit Program
2/11/80	GGD-80-34: IRS Efforts To Detect And Pursue Corporate Nonfilers
9/5/80	GGD-80-98: IRS Needs To Reconsider Its Examination Strategy For Certain Partners
10/16/80	GGD-81-20: New Formula Needed To Calculate Interest Rate On Unpaid Taxes
10/20/80	FGMSD-84-4: IRS Can Expand And Improve Computer Processing Of Information Returns
4/29/81	GGD-81-25: Streamlining Legal Review Of Criminal Tax Cases Would Strengthen Enforcement Of Federal Tax Laws
5/12/81	GGD-81-66: Observations Concerning the Internal Revenue Service's Management of Criminal Tax Cases
7/8/81	GGD-81-83: Illegal Tax Protesters Threaten Tax System
7/23/81	GGD-81-80: Bank Secrecy Act Reporting Requirements Have Not Yet Met Expectations, Suggesting Need for Amendment
11/5/81	GGD-82-4: What IRS Can Do To Collect More Delinquent Taxes

Congressional Testimonies

7/16/79	Before the House Ways and Means Subcommittee on Oversight on IRS' efforts to identify and pursue income tax nonfilers and underreporters
7/17/79	Before the House Ways and Means Subcommittee on Select Revenue Measures on compliance problems of independent contractors
9/6/79	Before the House Government Operations Subcommittee on Commerce, Consumer, and Monetary Affairs on the subterranean economy
10/11/79	Before the House Ways and Means Subcommittee on Oversight on the efforts of IRS' Criminal Division to detect and deter underreporters
11/15/79	Before the Joint Economic Committee on the underground economy
11/29/79	Before the House Banking, Finance, and Urban Affairs Subcommittee on General Oversight and Renegotiation on the use of currency and foreign account reports to detect narcotics traffickers
12/13/79	Before the Senate Governmental Affairs Permanent Subcommittee on Investigations on IRS' Efforts to Combat Narcotic Traffickers
9/18/80	Before the House Ways and Means Subcommittee on Oversight on the subject of compliance by Federal Agencies with the requirements to file 1099 information returns
10/1/80	Before the House Government Operations Subcommittee on Commerce, Consumer, and Monetary Affairs on IRS' document matching program
10/1/80	Before the House Banking Finance, and Urban Affairs Subcommittee on General Oversight and Renegotiation on Implementation of the Bank Secrecy Act's Reporting Requirements
5/11/81	Before the House Ways and Means Subcommittee on Oversight on the adequacy of IRS compliance resources for fiscal year 1982
6/10/81	Before the House Government Operations Subcommittee on Commerce, Consumer, and Monetary Affairs on IRS' efforts against illegal tax protesters

7/23/81	Before the House Banking Finance, and Urban Affairs Subcommittee on General Oversight and Renegotiation on the Bank Secrecy Act
3/17/82	Before the House Government Operations Subcommittee on Commerce, Consumer and Monetary Affairs on the adequacy of IRS' resources

Current Reviews

(1) Review of problems IRS encounters in auditing tax shelter schemes

(2) Review of the quality of IRS' corporate tax return audits

(3) Review of IRS' resource management activities

(4) Review of IRS' use of publicity to promote voluntary compliance with the tax laws

(5) Survey of IRS' rewards for information program

(6) Survey of IRS' unreported income program

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
EXPECTED AT 10:00 A.M. EST
WEDNESDAY, MARCH 17, 1982

STATEMENT OF
WILLIAM J. ANDERSON, DIRECTOR
GENERAL GOVERNMENT DIVISION
BEFORE THE
SUBCOMMITTEE ON COMMERCE, CONSUMER AND MONETARY AFFAIRS OF THE HOUSE COMMITTEE ON GOVERNMENT OPERATIONS
ON THE ADEQUACY OF IRS' RESOURCES

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist your Subcommittee in considering the adequacy of IRS' resources, particularly its resources for fiscal year 1983. Our testimony is based primarily on our overall experience gained from conducting audits of tax administration operations and activities. Over the past several years, we have reviewed and reported on most of IRS' major programs and activities. We will soon issue a comprehensive report on how IRS allocates resources among its various compliance programs.

The thrust of our testimony today, Mr. Chairman, is that IRS needs additional resources to effectively administer our Nation's tax system and collect the revenues required to defend and operate our country. Of course, we continue to believe that administrative and legislative actions can be taken which would allow IRS to make more efficient and effective use of its existing resources. However, these actions alone will not be sufficient. IRS' workload continues to grow because of (1) the decline of voluntary compliance with the tax laws, (2) the increase in the scope and complexity of the laws IRS is charged with enforcing, and (3) the increase in the number of returns filed. IRS' resources have not kept pace with these trends. It is imperative that IRS have sufficient resources to maintain the integrity of our tax system and collect the revenues necessary for financing essential Government activities.

IMPORTANCE OF TAX COLLECTION ACTIVITIES

The Federal Government's financial well-being depends, in large measure, on whether people are willing and able to support our Nation's tax system. The system, which is based on voluntary compliance, is generally regarded as the most efficient, effective, and fair approach for carrying out the unpopular function of collecting the revenue necessary for national defense and other essential Government activities. As shown in attachment I to my statement, our tax system provides over 90 percent of the revenues for financing the Government's programs and activities. In 1981, the system provided about $600 billion in revenue from all sources, and IRS' budget was $2.5 billion. Thus, the average cost to collect $100 was just 41 cents.

To assure that the tax system provides maximum revenue at least cost, IRS must strive to achieve the highest possible degree of voluntary compliance with the tax laws. But, growing numbers of people in this country are unwilling to comply voluntarily, and even a slight decrease in compliance levels translates into billions of dollars of foregone tax revenue annually. This is very significant in view of the huge deficits the Federal Government incurs to meet its obligations.

TAXPAYER COMPLIANCE HAS DECLINED

Despite the importance of our Nation's tax system, it is not in as good health as it should be. There is a trend toward contempt and abuse of the system which seriously undermines the basic concept of voluntary compliance on which the system depends. Extensive evidence is available to show that noncompliance among both corporate and individual taxpayers is a serious problem and is getting worse.

One source of evidence is IRS' September 1979 report on income not reported by individuals for tax purposes. This study, coupled with other IRS data, shows that for tax year 1976 individual taxpayers failed to pay taxes totaling up to $27.6 billion. This shortfall resulted from four types of noncompliance:

--Failing to report all income on which tax is due ($20.0 billion).

--Nonfiling of returns by persons with tax liability ($2.5 billion).

--Failing to pay tax reported on returns filed ($1.5 billion).

--Overclaiming of deductions, exemptions, and credits ($3.6 billion).

Had individual taxpayers alone fully complied with the tax laws in 1976, the additional taxes generated would have reduced the fiscal year 1977 Federal budget deficit by 58 percent.

IRS is updating and expanding its 1976 figures and will release new estimates soon. However, some preliminary estimates, not yet finalized and publicized by IRS, indicate that the total tax revenue losses may have tripled since 1976.

Another source of evidence is IRS' Taxpayer Compliance Measurement Program (TCMP), which periodically estimates voluntary compliance levels among individual taxpayers and some corporations who file returns. These studies provide the best available measure of noncompliance involving the overstating of offsets to income (exemptions, deductions, and credits). However, IRS has made other studies which indicate that TCMP detects less than one-half of the estimated unreported income. As shown in attachment II to my statement, unreported income, which is commonly associated with the subterranean or underground economy, is the largest form of noncompliance--accounting for almost three-fourths of the estimated foregone tax revenue in 1976.

Even though TCMP surveys do not measure total taxpayer noncompliance, the results of those surveys can provide some insight into voluntary compliance trends since 1965. These studies show that in the 11 years from 1965 to 1976, compliance rates, in terms of dollars of tax liabilities accurately reported, dropped by 2 percent, from 94.3 percent to 92.3 percent. Had the compliance rate remained at the 1965 level of 94.3 percent, tax assessments in 1976 would have been $9 billion higher.

Compliance among certain taxpayer classes has seriously deteriorated since 1965. Compliance among four of the seven classes IRS measures was below 90 percent in 1976; whereas just one class was below 90 percent in 1965. For example, compliance among individual taxpayers who own small businesses with under $10,000 income dropped from 79.2 percent in 1965 to 43.2 percent in 1976. That means that these taxpayers as a class paid only 43 percent of the taxes they owed in 1976.

The noncompliance problem is not restricted to individual taxpayers. For example, according to TCMP results, compliance among small corporations, those with assets of up to $1 million, dropped about 10 percentage points, from 83.1 to 73.3, between 1969 and 1978. Tax revenue losses for the three corporate classes IRS measured through TCMP in both 1969 and 1978 more than doubled, from $600 million to $1.3 billion between those years. Compliance among those three classes of corporate taxpayers was 88.0, 90.7, and 63.0 percent in 1978. For all the corporate taxpayers measured through TCMP in 1978, including some not measured in 1969, the estimated tax loss was $2.3 billion for 1978. As with individual taxpayers, the major form of the corporate noncompliance was unreported income, comprising about two-thirds of the noncompliance among corporate taxpayers.

Along with the general decline in voluntary compliance among both individual and corporate taxpayers, several special compliance problems and issues have emerged in recent years which further jeopardize the tax system. These include: (1) abusive tax shelters; (2) tax protesters; and (3) use of overseas tax havens. While each of these problems is complex enough to merit its own testimony, I will just highlight them.

--IRS considers the proliferation of abusive tax shelters to be a major tax compliance problem. IRS reports that some 248,000 tax returns involving abusive tax shelters were under examination at the end of fiscal year 1981, at least 50,000 more than 1 year earlier. IRS estimates that abusive tax shelters cost the Government approximately $3.6 billion annually in lost revenue.

--Illegal tax protesters are those who advocate and/or participate in certain schemes that result in tax evasion. IRS estimates that the number of protester returns filed in 1981 totaled about 27,300--a 283 percent increase from 7,100 in 1978.

--Use of overseas tax havens has grown rapidly in the past several years. Because of inherent limitations on U.S. information gathering and enforcement activities in foreign countries, tax havens are an exceedingly difficult compliance problem.

INCREASING SCOPE AND COMPLEXITY OF TAX LAWS

Interrelated with the noncompliance problem is the scope and complexity of the tax laws which has added to IRS' administrative burden. The tax laws often complicate IRS' audits of tax returns and produce numerous controversies between IRS and taxpayers. Resolving these controversies has become a troublesome and expensive matter for both the Government and the taxpayer.

Recently enacted legislation has created even greater difficulties in interpreting and enforcing the tax laws. For example, while the Economic Recovery Tax Act of 1981 may have simplified tax administration in some areas, it complicated the tax system in others. Those areas, to mention a few, relate to indexing tax rates for inflation, various savings incentives such as IRAs, and the marriage tax penalty. The Economic Recovery Tax Act alone amended, added, or repealed over 200 sections of the Internal Revenue Code.

Changes due to the Economic Recovery Tax Act and other legislation in recent years created the need for new regulations. Available figures show regulations awaiting promulgation increased from 140 in January 1967 to 378 in January 1982, a 170 percent increase. Major tax legislation has caused sizable increases in the backlog; for example, the Economic Recovery Tax Act alone is responsible for 90 new regulations which are scheduled for completion by 1984. The priority assigned to these new projects impacts on the existing backlog by causing further delays in already pending projects.

Legislative changes have also created the need for new and revised tax forms, schedules and instructions. Between 1977 and 1981 such changes resulted in 46 new tax forms and 1,093 revisions to existing forms, 429 of which related to the Economic Recovery Tax Act.

In addition, because of the increasing complexity of the laws, taxpayers are more frequently objecting to IRS' audit determinations and taking advantage of their rights to appeal faster than IRS and the courts can hear the cases. As a result, the IRS Appeals Division backlog increased 2 percent from September 30, 1980, to September 30, 1981, when more than 27,000 cases were awaiting appeals actions. The rate of backlog growth in the courts is much greater, especially in the U.S. Tax Court where the number of cases pending trial increased from 34,000 to 45,400, or 33 percent, between September 1980 and September 1981.

Furthermore, Mr. Chairman, we note as perhaps another indicator of the increasing scope and complexity of the tax laws that, for the first time ever, the Commerce Clearing House published the tax code in two volumes this year rather than one.

IRS' COMPLIANCE RESOURCES HAVE NOT KEPT PACE WITH GROWING WORKLOAD DEMANDS

As the Federal agency responsible for administering the Nation's tax system, IRS must cope with an increasing workload created by the year-to-year growth in the taxpaying population as evidenced by the increasing number of tax returns filed.

Of course, IRS must also respond to additional workload created by deteriorating compliance and by new tax legislation. IRS has one of the largest workforces of all Federal nondefense agencies and is requesting $2.9 billion to support 88,700 staff years for fiscal year 1983. In the past several years, however, its resources have not kept pace with the growth in its workload.

IRS expects 144 million tax returns to be filed in 1983, including 8 million Form 1040s and Form 1040As. In contrast, only 123 million were filed in 1976, including 83 million Form 1040s and Form 1040As. This is an overall growth of 17 percent. While increases in return filings do not necessarily require proportionate increases in IRS resources, it is still noteworthy that, between 1976 and 1983, the number of returns filed will increase by 17 percent. IRS' resources, however, will increase by only 5 percent, from 84,300 to 88,700 staff years--about a third the rate of the workload increase.

Attachment III to my statement shows the resources and workload trends for major IRS components for fiscal years 1976 through 1983. To illustrate the increasing demands being placed on IRS resources, I would now like to discuss several specific IRS programs and activities.

IRS' examination resources have failed to keep pace with the increase in tax return filings, and the tax revenue shortfall is increasing. As mentioned earlier, filings will increase 17 percent from 1976 to 1983. However, examination resources received from 1976 to date and requested for 1983 will have increased by only 2 percent. This 17 percent increase in filings, combined with the increasing complexity of the returns filed, will reduce coverage from 2.6 percent in 1976 to an expected 1.67 percent in 1983.

Based on TCMP data, IRS projected that a total of $19.8 billion in additional taxes were not assessed in 1980. However, at the 1980 coverage level of 2.12 percent of 1979 filings, IRS' examinations resulted in a recommended $2.8 billion in additional taxes for individual tax returns--a shortfall of $17 billion. IRS recently made preliminary estimates that this tax shortfall is growing at an annual compound rate of 13.5 percent. At this rate, the cumulative shortfall could be as much as $135 billion for the 5 years 1981-85.

IRS' collections resources have also failed to keep pace with growing delinquent account inventories. According to IRS, tax revenue tied up in delinquent accounts will almost triple between 1976 and 1982--increasing from $1.7 billion involving 614,000 accounts in 1976 to an estimated $4.8 billion involving 1.5 million accounts. However, these figures understate the total collection problem because they refer only to the year-end inventories of active accounts receivable. On this basis, IRS would have reported $4.7 billion not collected at the end of fiscal year 1981--but the actual amount outstanding was $20.5 billion. In addition to the $4.7 billion, the $20.5 billion included:

--Accounts which were in notice process ($8.8 billion).

--Accounts classified as currently not collectible ($3.9 billion).

--Installment and deferred accounts ($.8 billion).

--Accounts set aside for further investigation or adjustment ($2.3 billion).

Despite large increases in delinquent accounts, IRS resources devoted to the collection of such accounts was about the same in 1980--about 9,400 staff years--as it was in 1976. However, IRS is requesting an increase to about 10,800 staff years for 1982 and to about 13,700 staff years for 1983. With those higher staffing levels, IRS expects the ratio of active accounts to staff years to be improved.

The fact that IRS is required to administer new and often extremely complex tax laws has also impacted on its resources. The Crude Oil Windfall Profit Tax Act of 1980 is one example. This act is expected to raise more than $227 billion in net additional revenue by 1990. As I stated before this Subcommittee on April 13, 1981, the act is very complex and present compliance levels are unknown. IRS had to undertake this major new responsibility with no increase in resources to date. One result will be an estimated $150 million in foregone revenue that would have been generated annually by the examiners who were diverted from regular examinations to Windfall Profit Tax examinations.

ADMINISTRATIVE AND LEGISLATIVE IMPROVEMENTS COULD HELP CLOSE THE GAP BUT ADDITIONAL RESOURCES ARE ALSO NEEDED

Various administrative and legislative actions would permit IRS to make more efficient and effective use of its existing resources. However, such actions alone would not be sufficient to counter the growth in workload brought on by decreasing compliance, the increasing scope and complexity of the tax laws, and the increasing number of returns filed. Therefore, additional resources are needed if IRS is to maintain the integrity of the tax system and achieve maximum collection of Federal revenues.

Available Resources Can Be Used More Efficiently

Our work has shown that IRS can improve the management of its compliance programs and other activities to permit more efficient use of existing resources. We have noted, for example, that IRS is at a serious disadvantage in deciding how to best structure its compliance activities to better cause people to comply with the tax laws. IRS lacks sufficient data to understand how its compliance programs, individually and collectively, affect compliance. Even so, IRS has allocated more than half (about 54 percent in 1980) of its compliance-related resources to the examination program on the assumption that this program can achieve a 90-percent compliance level for all taxpayer groups.

Our work has shown that the examination coverage IRS has been able to provide has been inadequate to establish and maintain compliance levels at 90 percent or higher for some taxpayer groups. In fact, the compliance levels for all taxpayer groups that IRS measures have steadily declined since 1965. Furthermore, in allocating compliance resources to and within the examination program, IRS has purposefully foregone optimizing tax revenue. IRS has also favored the examination program over some other programs that are designed specifically to detect unreported income--the major compliance problem.

In a report soon to be released to the Congress, we are recommending several steps that IRS should take to better understand the compliance problem and to improve its resource allocations. Over the long run, IRS must do further research to obtain data on how and why its compliance programs influence the willingness of people to properly assess and pay their income taxes. Such data are essential to optimally allocate available resources in a way that best stimulates voluntary compliance.

In the short run, IRS should give greater emphasis to reducing foregone tax revenue in allocating resources among and within its compliance programs. To do that, IRS needs accurate data on the cost and revenue yield of its compliance programs. Generally, it has data showing only "average" dollar yields. IRS' management information systems do allow measurements of yield "at the margin" for the examination program, but they do not provide marginal yield data for other compliance programs.

Although IRS' cost/yield data must be used with caution, we can state with some confidence that additional resources in various programs would provide average revenue yields that significantly exceed average cost. This is particularly true for accounts receivable, where additional resources would have a sizable immediate impact on revenue collections. Unfortunately, however, the shortfall in IRS' management information is such that neither IRS nor we can estimate accurately how much revenue will be secured through an increase in resources or which programs provide the best dollar return for each additional investment. No one knows where diminishing returns will make further resource investment uneconomic at the margin.

In addition to administrative changes, legislative actions are needed in selected areas. Attachment IV to my statement lists legislative and administration recommendations still open which would contribute to improved compliance and/or IRS efficiency.

MORE RESOURCES ARE NEEDED

Even though IRS can use its resources more efficiently and effectively, the magnitude of the compliance problem and the increase in both the number and complexity of return filings pose demands for IRS so great that program efficiencies, including optimal resource allocations among programs, will go only so far in protecting the tax system. In our view, an increase in IRS' resources is warranted. Such an increase, within reason, would not increase the Federal budget deficit. This is because IRS' compliance programs, on the average, generate tax revenue in amounts that far exceed the programs' cost. For example, the average-yield-to-cost ratio was 8:1 for examination of returns and 21:1 for working delinquent accounts in 1981, according to data compiled by IRS. Additional information on program cost/yield ratios is given in attachment V to my statement.

In the fiscal year 1982 budget request, the Administration originally proposed a staff level of 88,000 for IRS. Concerned that this resource level might not be adequate, the House Ways and Means Oversight Subcommittee held hearings in May 1981.

During those hearings, we stated that IRS resources were insufficient to meet the demands of a growing workload and the problem of deteriorating compliance.

As we suggested during those hearings, IRS provided, at the Subcommittee's request, estimates showing that substantial tax revenue gains could be achieved through relatively small increases in IRS' budget. After analyzing the data provided by IRS, the Oversight Subcommittee wrote the House Appropriations Subcommittee requesting that IRS' appropriation be increased by 1,500 additional staff years and $38 million. IRS estimated that with those additional resources, it could generate additional revenue totaling $275 million, a 7:1 yield ratio, and could answer 1 million additional taxpayer inquiries. The House Appropriations Subcommittee approved the suggested increase. The Senate Appropriations Subcommittee reduced the amount but still approved a resource level higher than the Administration had requested. However, because of subsequent Administration activities and the Congress' decision to let IRS operate under a continuing resolution, the actual resources made available to IRS totalled less than 85,000 positions.

If the Administration's request for supplemental appropriations is approved without change, IRS will realize about 85,400 average positions and about $2.6 billion in fiscal 1982. According to IRS estimates, these reduced resource levels will result in the lowest examination coverage ever, 1.58 percent; a huge accounts receivable inventory of 1.5 million accounts totalling $4.8 billion; and, the greatest Tax Court backlog ever, over 45,000 unresolved cases.

I would now like to specifically discuss the adequacy of IRS' fiscal year 1983 budget request. The request shows a staff level of 88,700 and $2.9 billion in planned expenditures. This represents an increase of about 3,300 average positions and $328 million above the estimated fiscal year 1982 levels--a 4 percent increase in staff years. However, it is also 50 staff years less than the lowest level initially approved by the House and Senate Appropriation Subcommittees for fiscal year 1982.

The fiscal year 1983 budget does reflect a shift in resources to a seriously underfunded program. IRS proposes to increase resources for delinquent accounts by 3,000 average positions over the fiscal year 1982 level. However, increases scheduled for examination are less than 1,000 positions, raising expected examination coverage by only .09 percent to 1.67 percent. And, with only modest increases in resources for some other programs, IRS will still be unable to keep pace.

The Administration proposes to substantially cut back on IRS' taxpayer assistance activities. Already, IRS has eliminated direct return preparation assistance at walk-in offices and, in total, it expects to provide assistance to 41.4 million taxpayers in fiscal year 1982, 3.4 million fewer than the 44.8 million served in fiscal year 1981. In fiscal year 1983, IRS expects to be able to provide assistance to only 19.4 million taxpayers as its taxpayer assistance staff year allocation declines from about 4,100 to 2,400.

Neither we nor IRS know who will be affected by the cutbacks or how the affected persons will react. We have initiated a major review of IRS' taxpayer assistance activities to obtain information on, among other things, the population groups IRS serves. Until we have completed our work, it is unlikely that the Congress will know which specific taxpayer groups will be most affected by proposed cutbacks. Once these groups have been identified, it may well be possible to better predict the actual effects of the proposed cutbacks.

Also, varying resource levels create a highly disruptive effect on the Service's operations. IRS was authorized about 87,500 staff years in fiscal 1980; 86,200 in 1981; and, 85,400 in 1982. The request for 1983 is 88,700. This racheting of staffing levels makes it extremely difficult to develop well-founded plans for acquiring, training, and focusing human resources on the multifaceted task of administering the tax system. A larger and more consistent level of resources to keep pace with growing demands on the tax system appears in order.

- - - - -

While we know that the compliance problems with the Nation's tax system require attention, we cannot state precisely to which programs additional resources could be allocated to optimize use of all available resources. We do know, however, that additional resources in some programs will result in a large and immediate flow of tax revenue to the Treasury. These resources are not only justified by the potential revenue gains, but--of equal or more importance--by the need to cope with IRS' increasing workload due to decreasing voluntary compliance, increasing tax law complexity, and increasing taxpaying population.

There are fundamental questions of fairness and of taxpayers' perception which, we think, should also be kept in mind when considering IRS' budget request. Is it fair that the vast majority of taxpayers, despite these difficult economic times, manage to pay their proper share, while

--the returns of many taxpayers with high potential for tax change go unaudited,

--tax evasion goes uninvestigated, and

--unpaid taxes are written off?

Taxpayers' perceptions that others can get away with not complying jeopardizes the entire system. For example, one reason for the growth of the tax protester movement seems to be the apparent success of some protesters who manage to delay or completely avoid paying taxes.

In closing, let me set forth some considerations that the Congress should keep in mind in deliberating on the desirablility of providing IRS with more resources.

First, IRS' unique role should be recognized, and the agency should be treated separately on any initiatives aimed at paring the size of the Federal work force. The rest of Government can essentially be lumped together and characterized as the "expenditure side." With some minor exceptions, IRS stands alone on the "revenue side." Actions to cut the cost of Government and scale back the pervasive Federal presence should not be indiscriminately applied to this agency and its special mission.

Second, it is important to keep in mind that IRS' various compliance activities do no more than require citizens to pay those taxes that were properly due in the first place, and that in fact were so paid by most of their number. Effective compliance should not be viewed as representing a special burden to the public at large; rather it is aimed at ensuring that all share their fair burden.

Finally, with respect to the question at hand, namely how many additional resources should IRS be provided with, let me offer the following. There is no doubt that IRS can return in added revenue some multiple of the additional funds it is proided. The problem, however, is trying to identify the optimum application of any finite amount of such resources. Given the lack of available data for making optimum allocations, the best approach might be to ask IRS to come forward again with its informed judgment on how various incremental funding increases would be applied. For example, as before, Congress could task IRS with calculating the operational, revenue, and cost impacts of personnel gains of some staff-year increment, 500 for example, ranging up to perhaps a total increase of 5,000 people.

Let me caution, however, that the resources provided must be adequate for the agency to meet its basic management information needs, such as (1) the need for research to better understand how its activities affect voluntary compliance and

(2) the need to develop a management information system that will provide the marginal cost/yield data necessary for developing a more scientific approach to making resource determinations and allocations.

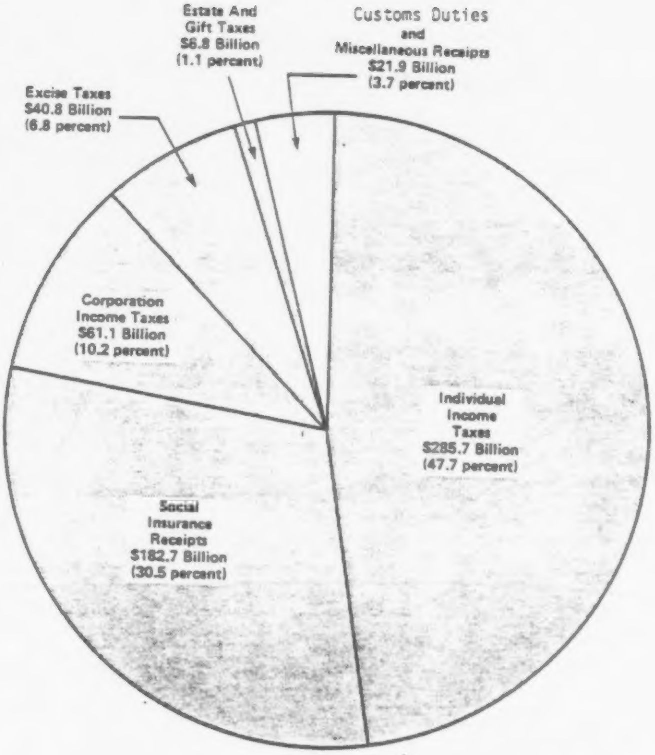
That concludes my prepared statement. I would be pleased to answer any questions.

ATTACHMENT I

ATTACHMENT I

FEDERAL REVENUES

Fiscal Year 1981 Actual

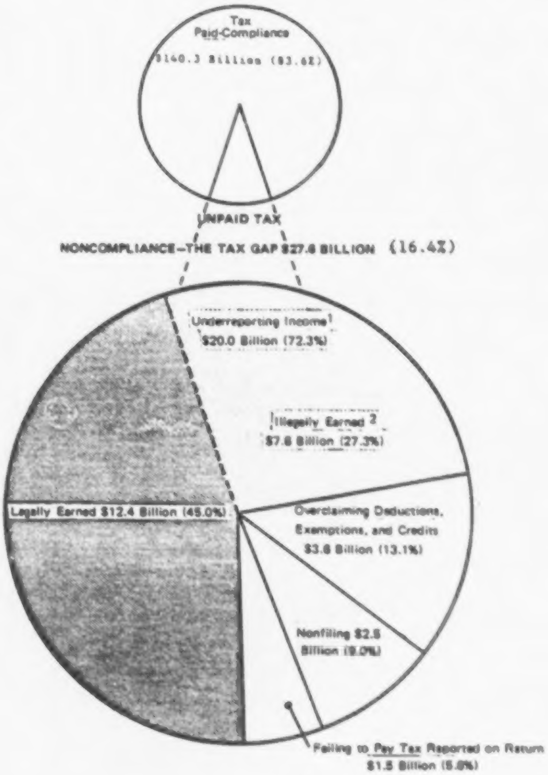


☐ Shaded portion indicates collections made by IRS.

Note: This chart shows receipts only. It does not show that portion of the budget financed through borrowing. Also, a small portion of the excise tax collections is the responsibility of the Bureau of Alcohol, Tobacco and Firearms, Department of the Treasury

ESTIMATED INDIVIDUAL INCOME TAX OWED U.S. IN 1976

TOTAL $167.9 BILLION



[1] Excludes underreported income from nonfilers.

[2] Estimate includes only major criminal activity.

IRS RESOURCES AND WORKLOAD BY PROGRAM
FISCAL YEARS 1976, 1982, 1983

	1976		1982		1983		Change 1976-83	
Program	Workload (000)	Staff years (note a)	Workload (000)	Staff years	Workload (000)	Staff years (estimates)	Workload (percent)	Staff years (percent)
Examination (note c)	123,361	28,164	128,264	27,882	130,422	28,764	+ 5.7	+ 2.1
Collection accounts receivable	614 inventory	9,415	1,478 inventory	10,774	705 inventory	13,730	+ 14.8	+ 45.8
Delinquent returns	281 inventory	1,849	724 inventory	3,711	815 inventory	4,091	+190.0	+121.3
Returns compliance	248 returns	442	23 returns	71	129 returns	373	- 48.0	- 15.6
Criminal investigation	8.1 invest.	4,090	5.7 invest.	4,361	5.7 invest.	4,361	- 29.6	+ 6.6
Information returns (note b)	462,000 doc. rec.	1,700	609,000 doc. rec.	2,968	614,000 doc. rec.	3,378	+ 32.9	+ 98.7
Total IRS staff years		84,264		d/85,363		88,673		+ 5.2
Total IRS appropriations		$1,691,520 (000)		d/$2,589,034 (000)		$2,917,159 (000)		+72.5

a/1976 staff years are not adjusted to reflect organizational shifts.

b/Information Returns is a multifunctional program and some of the staff years shown for that program are also included in the staff years for the other programs listed above.

c/Examination workload is prior calendar year filings.

d/Includes pending supplementals of 1,005 average positions and $123,483,000.

OPEN GAO RECOMMENDATIONS TO THE CONGRESS AND IRS TO IMPROVE COMPLIANCE AND/OR IRS EFFICIENCY

Congressional Recommendations	Source
1. Impose mandatory withholding on agricultural employees.	B-137762 3-26-75
2. Repeal occupational taxes on the alcohol industry.	B-137762 1-16-76
3. Adopt standards for determining whether an individual is an employee or self-employed.	GGD-77-88 11-21-77
4. Revise educational expense deduction to clarify tax status of educational grants.	GGD-78-72 10-31-78
5. Consider ways of imposing a late filing charge on taxpayers due refunds who file late.	GGD-79-69 7-11-79
6. Revise the personal casualty and theft loss deduction.	GGD-80-10 12-5-79
7. Modify disclosure provisions of 1976 Tax Reform Act.	GGD-80-76 6-17-80
8. Modify summons provisions of 1976 Tax Reform Act.	GGD-80-76 6-17-80
9. Streamline legal review of criminal tax cases.	GGD-81-25 4-29-81
10. Amend the Bank Secrecy Act of 1970 to require reauthorization of reporting requirements.	GGD-81-80 7-23-81
11. Provide that IRS can require certain information from U.S. subsidiaries of foreign parent corporations.	GGD-81-81 9-30-81
12. Make pension plan determinations by IRS mandatory for tax qualification.	HRD-81-117 9-30-81

Recommendations to the Commissioner of Internal Revenue (note a)	Source
1. Improve programs to collect taxes withheld by employers.	GGD-78-14 2-21-78
2. Improve utilization of currency transaction reports.	GGD-79-24 4-6-79
3. Develop and use an ADP Cost Accounting System in IRS.	GGD-79-48 6-18-79
4. Develop more selective system for detecting and investigating nonfilers.	GGD-79-69 7-11-79
5. Establish a system to check delinquent returns for unreported income.	GGD-79-69 7-11-79
6. Improve the corporate audit selection system.	GGD-79-43 8-3-79
7. Increase use of computer audit techniques in all compliance programs.	GGD-80-33 1-24-80
8. Strengthen efforts to detect and pursue corporate nonfilers.	GGD-80-34 2-11-80
9. Simplify estimated tax forms and instructions.	GGD-80-89 7-16-80
10. Improve the selection system for traditional partnership returns.	GGD-80-98 9-5-80
11. Expand and improve the computer processing of information returns.	FGMSD-81-4 10-20-80
12. Monitor districts' efforts to get newspapers to publish lists of individuals entitled to undelivered refund checks.	GGD-81-71 4-10-81
13. Streamline legal review of criminal tax cases.	GGD-81-25 4-29-81
14. Establish working group in each district to handle protester and other special compliance cases.	GGD-81-83 7-8-81

---

a/As of March 1982, IRS had many of these recommendations at various stages of implementation.

	Source
15. Prepare substitute tax returns with information from other sources.	GGD-81-83 7-8-81
16. Establish criteria on time allowed protesters before issuing a summons.	GGD-81-83 7-8-81
17. Develop a more comprehensive management information system pertaining to illegal tax protester efforts.	GGD-81-83 7-8-81
18. Develop and coordinate with Justice a plan for dealing with illegal tax protesters.	GGD-81-83 7-8-81
19. Seek approval of the Joint Committee on Taxation to disclose taxpayer return information for certain tax protester cases.	GGD-81-83 7-8-81
20. Consider ways to get a better measure of noncompliance with the requirements of section 482.	GGD-81-81 9-30-81
21. Reassess IRS' criteria for requesting economists' participation in section 482 adjustments.	GGD-81-81 9-30-81
22. Establish a procedure for communicating information among audit teams doing similar work	GGD-81-81 9-30-81
23. Clarify the description of information that corporations should report concerning the sale/purchase of stock.	GGD-81-81 9-30-81
24. Develop procedures to determine taxpayer filing compliance on pension payouts.	HRD-81-117 9-30-81
25. Discontinue program of granting installment-agreements-by-mail without determining ability to pay.	GGD-82-4 11-5-81
26. Develop a system for evaluating the effectiveness of the installment agreement program	GGD-82-4 11-5-81

YIELD/AVERAGE COST ESTIMATES

FOR SELECTED IRS PROGRAMS

FISCAL YEARS 1976 THROUGH 1983 (note a)

	Fiscal year							
	1976	1977	1978	1979	1980	1981	1982	1983
Examination								
Yield	$4,447	$4,084	$4,994	$4,863	$6,317	$6,688	$8,475	$9,576
Cost	$ 601	$ 632	$ 675	$ 720	$ 780	$ 836	$ 852	$ 935
Yield/cost ratio	7.4	6.5	7.4	6.8	8.1	8.0	8.4	10.2
Criminal investigations								
Yield	8,797	8,361	8,733	8,700	7,114	6,608	6,543	5,659
Cost	$ 100	$ 105	$ 121	$ 130	$ 154	$ 151	$ 141	$ 171
Cost per invest.	$11,367	$12,558	$13,855	$14,942	$21,647	$22,851	$21,550	$30,217
Accounts receivable								
Yield	$3,492	$3,069	$3,315	$4,900	$6,000	$5,584	$6,379	$7,792
Cost	$ 179	$ 188	$ 201	$ 213	$ 219	$ 255	$ 295	$ 399
Yield/cost ratio	19.5	16.3	16.5	23.0	27.4	21.0	21.6	19.5
Delinquency investigations								
Yield	$407	$363	$435	$839	$1,309	$1,403	$1,568	$1,856
Cost	$ 35	$ 36	(b)	$ 62	$ 73	$ 91	$ 102	$ 119
Yield/cost ratio	11.6	10.1	(b)	13.5	17.9	15.4	15.4	15.6
Returns compliance								
Yield	$133	$138	$125	$21	$18	$14	$6	$54
Cost	$ 8	$ 10	(b)	$ 6	$ 6	$ 4	$2	$11
Yield/cost ratio	16.6	13.8	(b)	3.5	3.0	3.5	3.0	4.9
Document matching								
Yield	$130	(b)	$219	$227	$311	$459	$511	$725
Cost	$ 24	$39	$ 52	$ 57	$ 63	$ 87	$ 74	$ 87
Yield/cost ratio	5.4	(b)	4.2	4.0	4.9	5.3	6.9	8.3
Math error								
Yield	$662	$716	$1,068	$1,270	$1,242	$1,687	(b)	(b)
Cost	(b)	(b)	(b)	(b)	(b)	(b)	(b)	(b)
Yield/Cost ratio	(b)	(b)	(b)	(b)	(b)	(b)	(b)	(b)

a/Yield is measured in millions of dollars of net assessments except for the Criminal Investigations and the Accounts Receivable Programs. The Criminal Investigations Program is measured in total investigations; the Accounts Receivable Program in millions of dollars collected.

b/Data not readily available.

Chairman Rostenkowski. Thank you, Mr. Anderson.

Are there any questions of Mr. Anderson?

[No response.]

Chairman Rostenkowski. Thank you very much.

Mr. Anderson. Thank you, sir.

Chairman Rostenkowski. The Chair calls Mr. Kurtz, Mr. Alexander, and Mr. Ferguson.

The Chair would like to announce that it is the intention of the Chair to work through lunch. So if anybody who will be participating in our panel discussions later, cares to adjust their schedules, please do so.

Welcome to the committee, gentlemen. It is always nice to have you back with us. Mr. Kurtz, if you would like to identify yourself for the record, you may proceed with your testimony.

STATEMENT OF JEROME KURTZ, ESQ., FORMER COMMISSIONER OF INTERNAL REVENUE

Mr. Kurtz. Thank you. Mr. Chairman and members of the committee:

My name is Jerome Kurtz. I am a practicing lawyer in Washington and appear pursuant to your invitation, in my individual capacity. My particular interest in the subject matter of H.R. 6300 results largely from my experience of having served as Commissioner of Internal Revenue under the previous administration.

H.R. 6300 and H.R. 5829 both address critical issues in the administration of our tax laws. Compliance is not what it ought to be and noncompliance breeds further noncompliance. Unless substantial steps are taken to improve compliance, we face the risk of losing the confidence of taxpayers in the fairness of our system. Without that confidence, the basis of our system of voluntary compliance will be jeopardized.

I would like to add that, while compliance is a very serious problem, I believe the current estimates of the tax gap being discussed by the Internal Revenue Service overstate the problem. The method of arriving at those estimates leaves much to be desired and produces estimates which seem to me, based on other estimates which have been done, to be very high. But even if the true figures are one-half or two-thirds of the estimates, the problem is severe, and I applaud this committee for facing the issues.

Because of the limited amount of time between the publication of the bill and this hearing, I am not in a position to comment on the legislation in detail. Therefore, my remarks will be fairly general.

First I would like to comment on a few issues not addressed in the bill, the first of which is the funding of the Internal Revenue Service. While it is true that these bills, if enacted into law, will aid the Internal Revenue Service in carrying out its responsibility to honest taxpayers to see that all pay their fair share, nevertheless without additional funding the Service will fall far short of meeting that responsibility.

The examination coverage of tax returns is at an all-time low. The number of cases pending in appeals and on the Tax Court docket is at an all-time high. Inventories of uncollected accounts receivable are virtually out of control. Even with the administration's proposed supplemental funding for the Internal Revenue Service, its staff will barely equal that which it had in 1980, without regard to increases in the number of returns being filed, the enactment of the windfall profits tax and other legislation creating new responsibilities for the Service.

Extended information reporting as proposed in these bills would obviously be helpful, but we should not lose sight of the fact that matching information documents does not produce revenue, nor does it produce compliance. It produces cases which require investigations, which in turn require people. Without the people to follow up mismatches and discrepancies an information reporting system is not productive.

I urge the members of this committee to do all they possibly can to see that the Service has adequate resources to carry out an efficient examination and collection program, to increase the percentage of returns examined, to apply adequate resources to complex returns, to handle appeals expeditiously, to litigate cases in a timely way, and to collect money admittedly due to the Government.

There is one tax administration tool that vastly improves compliance without the necessity of adding significant resources. That is withholding. I was very disappointed to read of the administration's decision to abandon its request for withholding tax on interest and dividend payments.

Our system works best when it works automatically and unobtrusively. Withholding produces these results. Compliance with reporting of wages subject to withholding is at the 99 percent level. Reporting in no other area comes close to this record. The same standard of compliance is readily achievable with very little additional burden on anyone through enactment of withholding in those areas where it can readily be applied: interest, dividends, and payment to certain independent contractors.

I would urge this committee to consider such actions. No arguments against withholding have been made that are not equally applicable to wage withholding. But that system works well. It is the cornerstone of the administration of our individual income tax and should be expanded.

Enforcement activity alone cannot achieve acceptable levels of compliance. Ours is, after all, basically a voluntary compliance system supplemented by enforcement. It requires a high degree of taxpayer cooperation to operate effectively and efficiently, and taxpayer cooperation, the willingness to comply voluntarily in the first instance, must be grounded in a widely held view that the tax system is fair, that all are paying their fair share, and that the Government is treating taxpayers fairly.

We cannot ignore the effects on compliance of the complexity of our tax laws, nor can we ignore the effect on compliance of the fact that recent legislation, in its eagerness to provide investment incentives, has subsequently reduced the tax burden on our highest income individuals and corporations, thereby intensifying the perception among average taxpayers of the unfairness of our system.

Fair administration is also crucial. The administration's 1983 budget request would eliminate substantive taxpayer assistance by telephone. If enacted as recommended, in 1983 over 25 million taxpayers who called the Internal Revenue Service in an average year to get answers to substantive tax questions will find that service no longer provided.

I believe the Government has an obligation to aid taxpayers in fulfilling their legal obligations. The least the Government can do if it expects taxpayers to comply voluntarily with our complex tax laws is to provide needed assistance.

In general, I believe the provisions of H.R. 6300 would substantially improve compliance and, while there may be details still be worked out or rough spots to be smoothed over, I feel the bill would be of substantial assistance.

The restrictions on the issuance of bearer obligations coupled with expanded information reporting would be a major step in improving compliance in the reporting of interest, particularly if supplemented with resources to follow through on mismatches and discrepancies.

The provisions on abusive tax shelters are critically important. This is a continuing major problem that the Service faces.

The improvements in the provisions relating to administrative summonses, which I assume Carr Ferguson will talk about in some detail, have long been advocated by the Treasury Department and the Department of Justice. Present law provides taxpayers with long delays which are not balanced in any way by protecting their rights. The bill would, without any lessening of taxpayer rights, expedite the use of summonses in the management of cases.

Title IV, dealing with transactions outside the United States, addresses a very substantial problem faced by the Service. Under our tax system, the taxpayer has the burden of establishing his taxable income and he should not be able to ignore that burden where he chooses to invest or do business outside the United States by citing the laws of foreign countries or foreign practices to deny the Service the data necessary to verify his reported income.

One of the more controversial provisions of H.R. 6300 is section 503, dealing with the interest surcharge on substantial understatement--the so-called no-fault penalty. This penalty is applicable to significant deficiencies and would apply in all cases unless waived by the Secretary based on a showing that the taxpayer had a reasonable basis for the understatement and acted in good faith.

H.R. 5929 has a similar penalty. It is 10 percent of the deficiency rather than an interest surcharge, and would be excused if the item giving rise to the understatement was disclosed by the taxpayer on his return.

I believe our system requires a penalty which will discourage taxpayers from entering into tax-motivated transactions by providing a down-side risk. Under existing law taxpayers invest in questionable tax shelter schemes because of the absence of such risks. On the one hand, the taxpayer's return may not be examined at all, in which case he gets his deductions. If his return is examined and he loses the case, as he probably expected he would, he nevertheless frequently loses nothing, because the tax otherwise due has been deferred at what traditionally has been a relatively low interest rate. He also has the possibility of settling his case for less than the full amount due.

The current high interest rates and other penalty provisions in these bills, I believe, will provide deterrents to entering into these very questionable schemes. But perhaps more is needed. Taxpayers should be required to make a calculation taking into account a significant down-side risk, one sufficient to discourage taxpayers from investing in transactions unless they believe there is a substantial likelihood that the promised tax benefits will materialize.

I do not believe that the provisions of H.R. 5829 will be effective in the tax shelter area, because the tax shelter deductions will, in fact, be disclosed on the return and the penalty therefore will not be applicable.

A requirement of disclosure is useful to the Internal Revenue Service in selecting appropriate returns for audit or in identifying issues on returns under audit. The problem in shelters is not primarily one of identifying the returns—the Service now has 250,000 under examination—but rather in managing the vast number of controversies.

The penalty must be effective to discourage the transactions in the first instance. Therefore, I would suggest that if disclosure is to provide relief from a penalty it should only provide relief in those cases where the transaction itself is not primarily tax motivated.

Under H.R. 6300 the penalty may be waived by the Secretary, provided the taxpayer shows that there was a reasonable basis for the understatement and the taxpayer acted in good faith. This standard is explained in the joint committee staff print prepared for this hearing. A good faith mistake as to the timing of a deduction is given as an example of grounds for waiver, while an understatement arising out of a tax-motivated transaction is an example where the penalty probably would not be waived.

These two examples, of course, leave a wide middle ground with little guidance. To achieve the desired results and uniformity of administration, I believe the standards for waiver should be described more specifically in the statute.

For example, it may be appropriate to specify that full disclosure will be considered evidence of good faith in a transaction which is not tax-motivated. Substantial authority supporting the taxpayer's position could also be specified as evidence of good faith.

On the other hand, a position contrary to a ruling, without disclosure, would show a lack of good faith in reporting a nonshelter transaction.

Just a word on the provisions relating to partnership and subchapter S audits and litigation. This problem has been studied by the Internal Revenue Service, various bar associations and various committee staffs for over four years. And I believe there is now a wide consensus that provisions such as those contained in this Act should be enacted to solve a very serious administrative problem.

And finally, I would express wholehearted support for the provisions of the bill which exempt Internal Revenue Service regulations and forms from OMB review. Internal Revenue regulations are extremely complicated. There is a great press for more regulations from the Internal Revenue Service, not fewer.

Taxpayers need the guidance, and the interposition of OMB in the review process with its small staff simply slows down that process and denies taxpayers the guidance they need.

I appreciate the opportunity to participate in these hearings and will be pleased to answer any questions that the committee might have.

[The prepared statement follows:]

STATEMENT OF JEROME KURTZ

Mr. Chairman and Members of the Committee: My name is Jerome Kurtz. I am a practicing lawyer in Washington, D.C., and appear pursuant to your invitation in my individual capacity.

My particular interest in the subject matter of H.R. 6300 results largely from my experience of having served as Commissioner of Internal Revenue under the previous administration.

H.R. 6300 and H.R. 5829 address critical issues in the administration of our tax laws. Compliance is not what it ought to be and noncompliance breeds further noncompliance. unless substantial steps are taken to improve compliance, we face the risk of losing the confidence of taxpayers in the fairness of our system. Without that confidence the basis of our system of voluntary compliance will be jeopardized.

I should add that while noncompliance is a very serious problem, I believe the current estimates of the "tax gap" being discussed by the Internal Revenue Service overstate the problem. The method of arriving at those estimates leaves much to be desired and produce estimates which seem to me, based on other estimates that have been done, to be very high. But even if the true figures are one-half or two-thirds of the estimates, the problem is severe and I applaud this Committee for facing the issues.

Because of the limited amount of time between the publication of the bill and this hearing, I am not able to comment on the legislation in detail. Therefore, my remarks will be fairly general.

I would like first to address a few issues not covered by either of the bills.

The first issue is the funding of the Internal Revenue Service. While it is true that these bills if enacted into law will aid the Internal Revenue Service in carrying out its responsibility to honest taxpayers to see that all pay their fair share, nevertheless, without additional funding the Service will fall far short of meeting that responsibility. The examination coverage of tax returns is at an all-time low. The number of cases pending in appeals and on the tax court docket is at an all-time high. Inventories of uncollected accounts receivable are virtually out of control. Even with the Administration's proposed supplemental funding for the Internal Revenue Service, its staff will barely equal that which it had in 1980 without regard to increases in the number of returns being filed, the enactment of the Windfall Profits Tax and other legislation creating new responsibilities for the Service.

Extended information reporting as proposed in these bills would obviously be helpful, but we should not lose sight of the fact that matching information documents does not produce revenue, nor does it produce compliance. It produces cases which require investigations which require people. Without the people to follow up mismatches and discrepancies an information reporting system is not productive. I urge the members of this Committee to do all they possibly can to see that the Internal Revenue Service has adequate resources to carry out an efficient examination and collection program; to increase the percentage of returns examined; to apply adequate resources to complex returns; to handle appeals expeditiously; to litigate cases in a timely way and to collect money admittedly due to the government.

There is one tax administration tool that vastly improves compliance without the necessity of adding significant resources. That is withholding. I was very disappointed to read of the Administration's decision to abandon its request for withholding tax on interest and dividend payments. Our system works best when it works automatically and unobtrusively. Withholding produces these results. Compliance with reporting of wages subject to withholding is at the 99 percent level. Reporting in no other area comes close to this record. This same standard of compliance is readily achievable with very little additional burden on anyone through enactment of withholding in those areas where it can readily be applied—interest, dividends and payments to certain independent contractors. I would urge this Committee to consider such action. No arguments against withholding have been made that are not equally applicable to wage withholding. But that system works well. It is the cornerstone of the administration of our individual income tax and should be extended.

Enforcement activity alone cannot achieve acceptable levels of compliance. Ours is, after all, basically a voluntary compliance system supplemented by enforcement. It requires a high degree of taxpayer cooperation to operate effectively and efficiently and taxpayer cooperation—the willingness to comply voluntarily in the first instance—must be grounded in a widely-held view that the tax system is fair, that all are paying their fair share, and that the government is treating taxpayers fairly. We cannot ignore the effect on compliance of the complexity of our tax laws. Nor can we ignore the effect on compliance of the fact that recent legislation, in its eagerness to provide investment incentives, has significantly reduced the tax burden on our highest income individuals and corporations, thereby intensifying the perception among average taxpayers of the unfairness of our system.

Fair administration is crucial. The Administration's 1983 budget request would eliminate substantive taxpayer assistance by telephone. If enacted as recommended, in 1983 over 25 million taxpayers who call the Internal Revenue Service in an average year to get answers to substantive tax questions will find that service no longer provided. I believe the government has an obligation to aid taxpayers in fufilling their legal obligations. The lest the government can do if it expects taxpayers to comply voluntarily with out complex tax laws is to provide needed assistance.

In general, I believe the provisions of H.R. 6300 would substantially improve compliance. While I have not had the opportunity to analyze all of the details of the bill, I would like to comment generally on some of its provisions.

1. The restrictions on the issuance of bearer obligations coupled with expanded information reporting would be a major step in improving the reporting of interest receipts and should be enacted.

2. Abusive tax shelters continue to be a problem. The provisions of H.R. 6300 imposing civil penalties on promoters of false or fraudulent schemes would, I believe, provide the Internal Revenue Service with a valuable tool to combat these abuses. So would the injunction action provided for in section 112 although this type of proceeding should be used very sparingly. The problem with the injunction action is that it would require a court to determine, as a prerequisite to granting an injunction, that the tax shelter scheme being promoted is not false or fraudulent. This would require an examination of the substantive tax implications of the scheme but against a standard of fraud rather than a standard of whether the tax benefits are, in fact, available. A decision for the promoter might encourage the scheme without any finding that the benefits promised are available.

3. The penalty for aiding, assisting, etc., in the preparation of documents used to understate tax liability would almost surely discourage the type of abusive conduct at which it is aimed. In the case of corporate directors, officers, employees and advisors, however, I believe the provision in H.R. 5829 is more appropirate and would be more effective. Our law should contain a substantial deterrent, short of criminal prosecution, to corporate directors and employees participating in tax fraud. Such a penalty would not interfere with the normal functioning of corporate officers and directors as some have argued. The line between the normal exercise of business judgment and fraud is quite clear under the law and would not, in my view, in any way inhibit normal corporate operations nor would it deter individuals from serving as corporate directors of officers.

4. The penalty for frivolous returns aimed at so-called "tax protesters" is overdue. It should be made clear that this penalty also applies to a frivolous W-4 form.

5. Improvements in the provisions relating to administrative summonses have long been advocated by the Treasury Department and the Department of Justice. Under present law there are substantial delays involved in enforcing administrative summonses without any corresponding benefit to taxpayers. Taxpayers' rights would be fully protected under the proposed revisions and unnecessary delays would be avoided.

6. As I said previously, my first preferenece for addressing the reporting gap in interest and dividends would be a system of withholding tax at the source of payment. Absent withholding, however, improved and expanded information reporting could make a major contribution toward improving compliance. The same may be said of payments to certain independent contractors.

The requirement for reporting by brokers would be a significant help in verifying compliance with the capital gains provisions of the Code.

The extension of withholding to certain payments where inaccurate taxpayer information is furnished is a substanital improvement over the current penalty system. I wonder, however, if the 10 percent withholding rate will be adequate to accomplish its goal.

H.R. 5829 has a provision requiring the reporting of charged tips. Because of the extraordinarily low compliance among taxpayers in reporting tip income, I would strongly urge that such a provision be included as part of any legislation reported by this Committee. While it is true that reporting of charged tips will not fully solve the problem of tip compliance, it would be a vast improvement over what we have today.

7. Title IV of H.R. 6300 dealing with transactions outside the United States addresses a very substantial problem faced by the Internal Revenue Service, particularly those parts dealing with the taxpayer's obligation to submit documents relating to foreign income. Under our income tax system, the taxpayer has the burden of establishing his taxable income. This is an essential component of a self-assessing system since it is the taxpayer who controls the information necessary to make the required computations. Our system cannot function if a taxpayer may deny the Internal Revenue Service the ability to verify his income and deductions on the grounds that such records are located outside the United States and that furnishing them might violate the banking or other laws of a foreign country. If the taxpayer chooses to do business abroad, he cannot use his choice as an excuse to refuse to comply with fundamental requirements of our tax system. The remedies provided in Title IV seem an entirely appropriate way of addressing these problems.

8. Clearly, interest on amounts due to taxpayers or to the government should be compounded. Whether this compounding should be daily as provided in H.R. 6300 or semi-annually as in H.R. 5829 depends on the ability of the Internal Revenue Service to manage such computations efficiently and expeditiously and on the ability to furnish taxpayers a simple method of doing these computations.

Both bills, however, maintain the parity in existing law of the interest rates paid by the government and that paid by taxpayers. I believe it would be appropriate to reexamine this concept of parity. Interest rates obviously vary in the commercial world depending on the creditworthiness of the borrower. The United States Government borrows at the lowest interest rates. For a taxpayer to be able to borrow at government interest rates will normally represent a substantial bargain and may well lead to a decision to defer tax payments to other obligations because the interest rates are lower on the tax payments.

Thought might also be given to charging different interest rates on different types of liabilities. For example, a substantial amount of overdue taxes represent taxes withheld from wages by businesses and not remitted to the government timely. Since there is no dispute in these cases as to the amount of tax due and since almost by definition the business is in a difficult financial position, the interest charge ought to be closer to that which the business is probably paying on its other borrowed funds so that it is discouraged from preferring other lenders to the Treasury.

Under present law, interest rates are changed only once a year and therefore at any given time are usually higher or lower than corresponding commercial rates. Under H.R. 5829 such interest rates would be determined semi-annually. That would be an improvement. Interest rates ought to be as current as the ability of the Internal Revenue Service to handle frequently-changing rates permits and on the ability to furnish taxpayers with a simple method of computation.

9. One of the more controversial provisions of H.R. 6300 is section 503 dealing with the interest surcharge on substantial understatements—the so-called "no fault" penalty. This penalty is applicable to significant deficiencies and would apply in all cases unless waived by the Secretary based on a showing that the taxpayer had a reasonable basis for the understatement and acted in good faith.

H.R. 5829 has a similar penalty. It is 10 percent of the deficiency rather than an interest surcharge, and would be excused if the item giving rise to the understatement was disclosed by the taxpayer on his return.

I believe our tax system requires a penalty which will discourage taxpayers from entering into tax motivated transactions by providing a downside risk. Under existing law, taxpayers invest in questionable tax shelter schemes because of the absence of such risk. On the one hand, the taxpayer's return may not be examined at all, in which case he gets his deduction. If his return is examined and he loses the case, as he probably expected he would, he nevertheless frequently loses nothing because the tax otherwise due has been deferred at what traditionally has been a relatively low interest rate. He also has the possibility of settling his tax case for less than the full amount due. He need have very little chance of success to avoid imposition of the negligence penalty under existing law.

The current high interest rates and the other penalty provisions in these bills, I believe, will provide deterrents to entering into these very questionable schemes, but perhaps more is needed. Taxpayers should be required to make a calculation taking into account a significant downside risk, one sufficient to discourage taxpayers from investing in a transaction unless they believe there is a substantial likelihood that the promised tax benefits will materialize.

I do not believe that the provision in H.R. 5829 will be effective in the tax shelter area because the tax shelter deductions will in fact be disclosed on the return, and the penalty would therefore not be applicable. A requirement of disclosure is useful to the Internal Revenue Service in selecting appropriate returns for audit or in identifying issues on returns under audit. The problem in shelters is not primarily one of identifying the returns—the Service now has 250,000 under examination—but rather in managing the vast number of controversies. The penalty must be effective to discourage the transactions. Therefore, I would suggest that if disclosure is to provide relief from a penalty, it should only provide relief in those cases where the transaction itself was not primarily tax motivated.

Under H.R. 6300, the penalty may be waived by the Secretary provided the taxpayer show that there was a reasonable basis for the understatement and the taxpayer acted in good faith. This standard is explained in the Joint Committee Staff print prepared for this hearing. A good faith mistake as to timing of a deduction is given as an example of grounds for waiver while an understatement arising out of a tax motivated transaction is an example where the penalty probably would not be waived. These two examples, of course, leave a wide middle ground with little guidance. To achieve the desired results and uniformity of administration, I believe the standards for waiver should be described more specifically in the statute. For example, it may be appropriate to specify that full disclosure will be considered evidence of good faith in a transaction which is not tax motivated. Substantial authority supporting taxpayer's position could also be specified as evidence of good faith. On the other hand, a position contrary to a ruling without disclosure would show a lack of good faith in reporting a non-shelter transaction.

10. The provisions relating to partnership and Subchapter S audits and litigations are essential for the efficient management of the tax system. This problem has been studied in the Internal Revenue Service, various bar associations and Committee staffs for over four years and I believe there is wide agreement that provisions such as these should be enacted.

These comments only deal with broad issues. There are, of course, details that the Committee may wish to consider. I would be pleased to be of whatever assistance in this consideration the Committee might consider helpful.

I will be pleased to address any questions you may have.

Thank you for the opportunity to participate in this very important hearing.

Mr. RANGEL [presiding]. Thank you, Mr. Kurtz.

Let me say before I forget that I want to thank this panel on behalf of the committee, especially Mr. Kurtz and Mr. Alexander, for continuing to allow your expertise to be made available to this committee and to its staff on the sensitive and key issues that come before it, and we will continue in the future to rely upon you to come forward. It is deeply appreciated.

And I would like to state for the record that I personally am glad of the direction which you were able to give this committee, as well as the Senate Finance Committee, on the administration's ill-founded proposal to take away from the IRS the ability to deny tax exemptions to racist schools. Obviously, you were in good company with the U.S. Supreme Court in reaching the decisions that you did while you served as Commissioner and sharing the reasons for that with this committee.

Mr. Alexander.

STATEMENT OF DONALD C. ALEXANDER, ESQ., FORMER COMMISSIONER OF INTERNAL REVENUE

Mr. ALEXANDER. Thank you, Mr. Chairman.

My name is Donald Alexander and I am appearing in my personal capacity, at the invitation of the committee.

I have a statement which I request be entered into the record, along with a letter that I would like to file later with respect to certain provisions that I have not had a chance to study.

Mr. RANGEL. Without objection.

Mr. **Alexander**. I do not propose to read any of the statement, Mr. Chairman.

I want to associate myself with what Commissioner Kurtz, former Commissioner Kurtz, stated about withholding. That is the way to go if you want to strengthen the tax system and make it work better and make it work more effectively and more efficiently, and I think, more responsibly.

I think that H.R. 6300 and H.R. 5829 are strong steps in the right direction. But I wonder if they go far enough. If we do indeed have a tax gap as great as the numbers that have been given you by the IRS today and on previous occasions, then we have a system that is not working very well. It may not be foundering, as the present Commissioner stated, but it surely is not very effective. It is not very efficient, and it is not very fair, because some people are shouldering a tax burden that others should be bearing.

Now, as to certain specifics, I discuss some of the provisions in the statement that I have submitted to this committee. I believe that many of these provisions are very helpful to an improved and more effective tax system. I want to associate myself with the view of the Department of Justice this morning. Commissioner Kurtz mentioned a minute ago that the administrative summons provisions enacted in 1976 have not proved to be of particular benefit to taxpayers as much as they have been a burden to the sound administration and enforcement of the tax laws.

Now is the time to move in the opposite direction. Now is also the time to strengthen penalties for failure to file information returns and to require more information returns.

I am a former member of the Commission on Federal Paperwork. Our charge in that Commission was to reduce and eliminate unnecessary paperwork. But some paperwork is necessary and the burden of supplying it is vastly outweighed by the benefits to our tax system of it being supplied and of it being used. And I want to associate myself with what former Commissioner Kurtz stated about the need for sufficient resources in the IRS to permit the use of the paper that these bills would require of the American public.

Finally, Mr. Chairman, I want to mention two things. One is that OMB review of IRS and Treasury regulations and forms is at best redundant. It can contribute little toward a sound tax system in which the Government is given the information that it must have to administer the system properly as taxpayers must have to make timely economic decisions on the basis of this system.

One of the things that the Paperwork Commission pushed for was enactment of a bill like the Paperwork Reduction Act of 1980, and I believe that the bill itself has been in the main good but for the fact that it impedes an already overly slow, overly tedious, and overly difficult process of issuing forms to those who must have them and guidance to those who must have it.

My last comment relates to section 101 of the chairman's bill, H.R. 6300. I think this is a step in the wrong direction. What it does—what it would do if enacted—is put IRS back in the business of making street busts of suspected narcotics traffickers.

We certainly need to deal with the narcotics traffic. We have an agency, the Drug Enforcement Administration, charged with that responsibility and given the authority to make forfeitures. I think we should call first upon that agency to find out why it apparently can't do its job, and give it resources and power to do its job.

No one has responsibility for enforcing the Internal Revenue Code except the IRS, and it weakens the IRS's ability to perform that responsibility when its best, most skilled agents are engaged in other tasks.

[The prepared statement follows:]

STATEMENT OF DONALD C. ALEXANDER

My name is Donald C. Alexander, and I am a partner in the Washington office of Morgan, Lewis & Bockius. I am testifying solely in my personal capacity, at the invitation of the Committee, to discuss H.R. 6300 and other proposals designed to improve tax compliance. As a former tax administrator with a deep and continuing interest in preserving the fairness and effectiveness of our self-assessment system, I want to commend the Committee, Chairman Rostenkowski and Representative Conable for tackling some unpleasant subjects and doing something about the alarmingly large and growing problem of the tax gap.

The effectiveness of our broad-based self-assessment tax system depends upon voluntary compliance. Voluntary compliance, in turn, depends upon public respect for the system as equitable and effectively enforced. Taxpayers are concerned that each pay his fair share.

While most taxpayers pay what they owe, this high rate of compliance is due primarily to withholding on wages and salaries. It is no secret that there are omissions in the existing compliance system—omissions which encourage and reward taxpayers for not reporting taxable income. The increase in the amount of unreported income since 1973 provides abundant evidence that some are taking advantage of the flaws in the existing system to avoid meeting their tax responsibilities.

IRS data for 1981 indicate that the amount of unreported income from legal sources, the "legal compliance gap", has tripled since 1973, from $29 billion to $87 billion. IRS projects that this "legal compliance gap" will reach $120 billion by 1985. Estimates of unreported income from illegal sources approximate $8 billion in 1981, up from $2.5 billion in 1973.

It is obvious that strong steps must be taken to improve taxpayer compliance, particularly in the legal sector. Improving compliance will produce two important benefits for our tax system: first, there should be an immediate increase in revenues from those directly affected; second, and more important, correcting the flaws in the existing system will help to preserve and strengthen voluntary compliance.

Both H.R. 6300 and H.R. 5829 are steps in the right direction. The way to improve compliance and increase revenues without increasing taxes is to strengthen Internal Revenue's tools and its resources. Because H.R. 6300 and H.R. 5829 became available to me only a few days ago, I have not had time to make a thorough review of many of the important provisions of these bills. With the Committee's permission, I would like to submit a letter to supplement this statement which is directed to particular provisions which I have had the opportunity to study. This letter would focus primarily on the proposed new penalties and the new provisions with respect to interest and audits.

However, I strongly approve the general thrust of the expanded penalty provisions and reporting requirements. Our present penalties are too weak to discourage scofflaws. In devising new penalties, one should make sure that penalties do not overshoot the mark and impose burdens disproportionate to their benefits. Such is the case with section 121 of H.R. 5829, identical to section 121 of S. 2198. This provision should be modified by reducing the dollar limitation, by limiting its application to intentional actions or failures to act, and by making other changes to reduce overkill.

As to information reporting, I favor limitations upon bearer instruments and the strengthened requirements and penalties in many other areas. Of course, it would be better to extend withholding.

I am pleased to see the Committee addressing the difficult and frustrating issue of access to information outside the United States. This presented a major problem to the IRS and has resulted in certain unfortunate actions—happily, only a few—by overzealous agents and informants. Strengthening IRS' powers to obtain this vital information is a great step forward to the effective and lawful enforcement of the tax laws. The IRS and Treasury should redouble their efforts to obtain effective and comprehensive treaties for the exchange of tax information.

WITHHOLDING AND REPORTING

We know, based on IRS statistics, where the largest present compliance gaps exist. These areas include income of commission agents and other independent contractors, gains on sales of assets. interest and dividends, and tips. Underreporting and nonreporting could be attacked best by mandatory withholding. Information reporting is helpful but it is not the full solution to the compliance gap—the solution that works is withholding.

In his March 16, 1982 testimony before the Finance Committee in opposition to a current effort to repeal withholding upon certain gambling winnings, Assistant Treasury Secretary Chapoton explained the great advantages of withholding as compared to information reporting. In my judgment, all of these advantages are present in the extension of withholding to other types of business income. To paraphrase Mr. Chapoton, withholding is an important compliance tool in two respects: first it provides an incentive for taxpayers who have substantial income to report that income accurately in order to claim the benefit of the withheld amounts on their returns; second, withholding provides a means of collecting at least a portion of the tax due from those who fail to file income tax returns. Additionally, withholding is a superior tax administration tool to information reporting because it "automatically" collects a portion of the tax liability without resort to audit and collection procedures, thus making better use of IRS resources. Withholding is also superior to information reporting because information reporting requires both accurate information documents and a properly filed income tax return to enable IRS to "match" the information as well as audit and collection staff to follow up discrepancies. In the absence of withholding, neither the payor nor the payee has any real incentive under current law to verify the accuracy of the statements made on the information return.

With respect to independent contractors and direct sellers, section 203 of H.R. 6300 creates a separate information reporting requirement for independent contractors and adds a new information reporting requirement for direct sellers. These reporting requirements, buttressed by the proposed increase in the penalties for failure to file information returns, certainly are a step in the right direction and I support them. I understand the pressures Congress is facing with respect to withholding on independent contractors and direct sellers—but withholding is the only method which will assure that taxes are paid. The omission of withholding on these groups is an invitation to continued noncompliance.

Section 103 of H.R. 5829 takes on an issue on which I labored unsuccessfully in 1976—withholding on charged tips. This section would require employers (excluding small employers) who pay to an employee more than $600 in charged tips any year to report such charged tips to IRS. Withholding on such charged tips would take place as under current law when the employee reports them to his employer.

Without auditing every taxpayer who receives tips, it is impossible to catch up with taxpayers who receive income in the form of cash. However, in the case of charged tips, the credit card receipt is a paper record of the tips. By using this paper record, the employer would merely add the amount of charged tips to the amounts currently reported by the employee. IRS fully understands that many tips are shared with others who do not appear to be the initial recipient, and that problem can be satisfactorily resolved. Employer reporting on charged tips offers a good opportunity to act on a chronic compliance problem.

IRS has identified unreported income from capital gains and interest and dividends, respectively, as the second and third largest areas of noncompliance. Both H.R. 6300 and 5829 take important steps to improve compliance in these areas. IRS recognizes that a portion of the problem is due to underreporting of gains on personal residences and collectibles, neither of which can be easily traced. However, one area which does present an opportunity for increased information reporting is gains from the sale of securities and commodities.

Both bills address the capital gains underreporting problem by requiring reporting by brokers. Since regulations under I.R.C. section 6045 were never issued, no information is available regarding gains from the sale of securities and commodities. Information reporting in this area is needed to obtain compliance.

Both bills address the compliance gap from unreported interest and dividends by dealing only with the exemption from reporting requirements. Both bills expand the definition of interest for information reporting and return requirements to include bearer securities and U.S. government securities. I support this expansion of the reporting requirements. However, the bills do not go far enough; they fail to address the more critical issue of withholding on interest and dividends.

Before I leave the subject of information reporting, I want to emphasize my support for increased penalties for failure to file information returns. The effectiveness of the new reporting requirements will be enhanced by a genuine deterrent for failure to file information returns. The addition of a new penalty for intentional disregard of the filing requirements is entirely appropriate.

ILLEGAL ACTIVITIES AND COMPLIANCE

I am concerned about section 101 of H.R. 6300 relating to jeopardy and termination assessments. I fear that this may do little to solve the tax gap and may divert IRS' scarce resources into activities far removed from enforcement of our tax laws.

In the late 1960's and early 1970's the quick termination and jeopardy assessment authorities of I.R.C. sections 6851 and 6861 often were used as devices to disrupt drug trafficking and other suspected illegal activities rather than as tools to collect taxes and protect the public revenues.

In a series of cases culminating with the Supreme Court's decision in *Laing* v. *United States,* 423 U.S. 161 (1976), the courts struck down this use of the Code's summary assessment procedures, finding no relationship to any tax liability and substantial hardship to the individuals involved. *See Laing* v. *United States, supra; Clark* v. *Campbell,* 501 F. 2d 108 (5th Cir. 1974); *Aguilar* v. *United States,* 501 F. 2d 127 (5th Cir. 1974); *Willets* v. *Ricardson,* 497 F. 2d 240 (5th Cir. 1974); *Lisner* v. *McCanless,* 356 F. Supp. 398 (D. Ariz. 1973); *Rambo* v. *United States,* 353 F. Supp. 1021 (D. Ky. 1972); and *Rinieri* v. *Scanlon,* 254 F. Supp. 469 (D. N.Y. 1966).

In 1974, IRS policy was changed to require that these harsh and unusual procedures be used primarily to assure compliance with the tax laws and not to assist or supplant other law enforcement agencies in their effort to police criminal activities.

In 1976, Congress enacted I.R.C. section 7429 which provided special procedures for expedited administrative and judicial review of the reasons for and the amount of jeopardy and termination assessments. Congress took this action to assure that even if the jeopardy and termination assessment authorities were misused, taxpayers would have recourse to an almost immediate review of the IRS position.

Section 101 of H.R. 6300 appears to go in precisely the opposite direction of the 1976 changes by explicitly expanding IRS authority to interfere in illegal activities. It establishes two presumptions with respect to cash used in illegal activities. First, if a person "possesses, controls or deposits" cash or "has recently possessed, controlled or deposited" cash thought to have been used in an illegal activity, the cash is presumed to be gross income and collection of the tax on such cash is presumed to be in jeopardy. Wholly apart from the extraordinary breadth of these presumptions, the authority conferred by the use of the term "recently" is extremely broad. One of Webster's definitions of "recent" would include events within the present epoch of geological time which dates from the close of the Pleisotocene epoch or Ice Age.

Section 101 also provides that if an individual is in possession of more than $10,000 cash which he does not claim as his and which is not identified as belonging to a third party, the cash may be presumed to represent gross income of a single individual and the collection of the tax in jeopardy.

What is the purpose of section 101? If it is to produce more revenue, I doubt whether it will achieve that objective and it will take IRS resources from areas where they could be used much more productively. Moreover, authorizing IRS to make "street grabs" of cash and other valuables contributes little to the goal of improving the tax system. The job of IRS is to administer and enforce the Internal Revenue laws; no other agency has this responsibility. IRS does not have the resources to take over the criminal enforcement mission of other agencies. The Drug Enforcement Administration has primary responsibility for enforcing drug laws. DEA has specific authority (21 U.S.C. § 881(a)(6)) to seize and forfeit money, negotiable instruments, or any other item of value used in connection with a violation of the drug laws. To the extent concerns about drug trafficking are the motivating force behind section 101, we should make certain that the agencies with front line responsibility for law enforcement do their job or explain why they can't do it. This is *not* to say—and I want to emphasize this point—that IRS should play no role. It should, and it does, do its best to enforce the tax laws against drug traffickers and other criminals who evade taxes.

OMB REVIEW OF TREASURY REGULATIONS

I want to express my wholehearted support for the provisions in both bills which relieve IRS and Treasury from oversight by the Office of Management and Budget with respect to regulations and rulings. As both a former member of the Paperwork

Commission and a tax administrator, I believe OMB review is unnecessary and inadvisable.

A small and untrained staff of budget examiners should not attempt to review highly technical tax regulations. OMB review only adds further delays to a process already too slow. The OMB staff is not qualified to offer any meaningful contribution. Obviously, creating such a staff would result in a largely redundant review at substantial cost.

CONCLUSION

I strongly support the Committee's efforts to improve taxpayer compliance. Both H.R. 6300 and H.R. 5829 contain important provisions with respect to improved information reporting and enforcement of such reporting which will help correct some of the omissions in the present system. Extending withholding would be the better solution in most situations. Section 101 of H.R. 6300 should be dropped.

It is true that additional withholding and information reporting requirements will impose an increased paperwork burden on the American public. This burden is more than compensated for by the benefits of better compliance by all taxpayers.

[The following was subsequently received:]

MORGAN, LEWIS & BOCKIUS
COUNSELORS AT LAW
1800 M STREET, N.W.
WASHINGTON, D.C. 20036
TELEPHONE (202) 872-5000

PHILADELPHIA
NEW YORK
LOS ANGELES

MIAMI
HARRISBURG
LONDON

DONALD C. ALEXANDER
DIAL DIRECT (202) 872-5045

June 4, 1982

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
Room 1102
Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Rostenkowski:

The purpose of this letter is to supplement my May 18, 1982 testimony on H.R. 6300, "The Tax Compliance Act of 1982" and related measures. These comments will focus on four general areas: penalties and interest; unified partnership and Subchapter S audits; availability of IRS resources; and expansion of the jeopardy and termination authorities.

Penalties and Interest

In my testimony, I noted that the tool which offers the greatest potential for substantially improved compliance is withholding. Nonetheless, it is appropriate to tighten the civil penalty provisions to deter aggressive and purposeful tax avoidance. New penalties should be structured carefully to address specific problems and not designed merely to make the existing system more punitive.

I favor the concept of a new penalty for promoters of abusive tax shelters. Similarly, IRS should have authority to enjoin the promotion of such shelters.

However, I am concerned that what contitutes the "promotion" of an "abusive tax shelter" be defined with care. Section 111 of H.R. 6300, as drafted, would apply to everyone engaged in the organization and sale of a tax shelter who "knows or has reason to know" that any statement made with respect to the tax benefits resulting from the plan is false or fraudulent regarding any material matter. Due to the number of people typically engaged in the organization of a partnership or other entity and the division of labor among them, the penalty should apply only to those who know a statement is false. Additionally, guidance should be offered with respect to what constitutes a "material matter."

The penalty also would apply to any of those involved in the organization and sale of a tax shelter in the case of a gross valuation overstatement. Again, I believe the penalty should apply only where a party has knowledge of the overstatement. We are all familiar with the case where the property (e.g., a photograph) is obviously overvalued. The harder issue involves a genuine dispute over the value of property, or property which is difficult to value. It would not be appropriate to apply the penalty automatically every time a partnership or other investment opportunity involves property with an uncertain value.

It is important that IRS be given authority to seek injunctions against the promotion of abusive tax shelters. An injunction in the promotional stages will be far more effective than attempting to audit each participant. A few well-chosen actions would eliminate the most offensive shelters.

I am concerned about the structure of the "no-fault" penalties contained in section 503 of H.R. 6300 and section 125 of H.R. 5829. I believe a deterrent to taxpayer's playing the "audit lottery" is timely and appropriate. Sophisticated taxpayers today take aggressive and thinly justified positions because there is little risk that the negligence or civil fraud penalties will be imposed as long as there is a "reasonable basis" for the position. The provisions in both bills would force taxpayers to look more closely at the validity of their positions. However, in keeping with my remarks above, I believe a deterrent must be carefully structured to avoid imposing unwarranted hardships upon ignorant taxpayers or in cases where there is a genuine disagreement regarding the validity of an IRS position.

Section 503 of H.R. 6300 would impose an interest surcharge of 20 percent of the interest payable on any underpayment due to a substantial understatement. Provision is made for IRS to waive the penalty if it is determined the taxpayer had a reasonable basis for the understatement and acted in good faith.

Section 125 of H.R. 5829 provides a penalty equal to 10 percent of any understatment only if the item(s) resulting in the understatement was not disclosed in the return. An understatement by an individual would be "substantial" if it exceeds the greater of $5,000 or 10 percent of the amount of tax required to be shown on the return. An understatement by a corporation would be substantial if it exceeds $10,000 or 10 percent of the amount of tax required to be shown on the return. Section 125 offers no guidance on how IRS will determine that a taxpayer has taken a questionable position on an undisclosed item. I would suggest you add a requirement that the penalty be applied only in those cases where, in addition to a failure to disclose, the taxpayer has taken a position contrary to the published position of IRS. Furthermore, I believe authority should be provided for the penalty to be waived in the case of a good faith error by a taxpayer or if clear judicial authority exists for the taxpayer's position. Additionally, even though excuse from the penalty rests on disclosure, it is not clear how IRS will determine adequate disclosure has taken place. As drafted, section 125 gives substantial discretion to IRS to judge subjectively whether disclosure has taken place. More guidance is necessary on what would constitute enough disclosure to avoid the penalty.

If the Committee opts for the interest surcharge concept of H.R. 6300, I would urge you to consider adding an exception similar to that contained in H.R. 5829 where the item is disclosed with the corrections I have discussed above.

I favor tightening the civil fraud penalty as provided in section 121 of H.R. 6300. This section would increase the fraud penalty by adding to the current penalty 50 percent of the interest payable on the portion of the underpayment attributable to fraud. This change in the fraud penalty complements the increase in the negligence penalty enacted last year and is entirely appropriate.

Both H.R. 6300 and H.R. 5829 provide new civil penalties for documents understating tax liability. Present law provides a criminal penalty for persons who willfully aid, assist in, procure, counsel or advise the making of a false or fraudulent tax return, affidavit, claim or other document under the internal revenue laws. Present law also imposes a penalty of $500 per return upon an income tax return preparer who willfully understates the tax liability of any person.

I support the Committee's objective to create a civil penalty which will parallel the existing criminal penalty for documents understating tax liability. However, I am concerned that such a penalty not overshoot its mark. I believe section 122 of H.R. 6300 is preferable to section 121 of H.R. 5829, although section 122 of H.R. 6300 also could be improved.

The penalty under section 121 of H.R. 5829 would apply to corporate directors, officers, employees or agents who "knowingly participate" in tax fraud of a corporation which results in an underpayment of tax by the corporation. The penalty would be an aggregate amount equal to 50 percent of the corporation's underpayment due to fraud, but not more than $100,000 per individual per return. "Knowing participation" is defined as "knew or should have known."

If the Committee proceeds with this provision, I would recommend the following changes. First, the dollar limitation should be lowered to $10,000 per person per return. I believe, and Treasury testified, that the $100,000 limitation is too high.

Second, the definition of "knowing participation" should be limited to "known" rather than including "should have known." As drafted, the standard is too broad and could result in imposing the penalty on the ignorant and inattentive as well as upon the willful.

Third, with respect to acts by a subordinate, the standard should be knowing of and "intentionally" not attempting to prevent a subordinate from participating in the fraud.

Finally, it should be made clear that the burden of proof in imposing the new penalty is on the Secretary.

Despite these modifications, I believe section 122 of H.R. 6300 is preferable. It provides a clear parallel to the existing criminal penalty. However, I question whether section 122 of H.R. 6300 should be broader than the criminal penalty it complements.

The penalty for frivolous returns contained in section 123 of H.R. 6300 is important to stop the growth in tax protest returns which clog the enforcement system. There simply is no excuse today to allow protest returns on long-settled issues to continue unpenalized. Policing tax protestors uses resources needed elsewhere. As drafted, this provision does not apply to false W-4 forms. It should be extended to apply to false W-4 forms.

The changes made by sections 131 - 133 of H.R. 6300 with respect to administrative summonses are, in general, sound. I am particularly pleased with section 131. Under section 131, if the taxpayer intends to prevent compliance with a summons by a third party recordkeeper, he must bring a proceeding to quash the summons within 20 days after notice of the summons was given. IRS could use the same proceeding to enforce the summons. The third party recordkeeper would have a right to intervene. No examination of the records could occur until after the 23rd day after notice of the summons was given.

This provision should reduce substantially the delays encountered under present law in enforcing administrative summonses. It will do so without sacrificing the concern for taxpayers' rights which motivated the enactment of section 7609 in 1976.

Finally, I favor compounding interest semi-annually as provided by section 111 of H.R. 5829. Compounding interest complements the decision to raise the rate of interest to more nearly reflect commercial rates and increases the cost of "borrowing" from the federal government through tax deficiencies. Along with a penalty for substantial understatements, compounding interest will increase the risks attendant to the "audit lottery." I do not oppose daily compounding as proposed in H.R. 6300 as a theoretical matter. However, I have doubts about the capability of IRS and taxpayers to handle a daily computation.

Unified Partnership and Subchapter S Audits

H.R. 6300 provides that the tax treatment of items of partnership income, loss, deductions and credits would be determined at the partnership rather than the individual partner level. Similar treatment is provided for Subchapter S corporations with determinations of items of income and loss determined at the corporate rather than the shareholder level.

The present system of auditing each partner separately, with the attendant possibility of inconsistent administrative and judicial resolutions involving the same issues, encourages abusive tax shelters. Even where abuse of the tax laws is not a problem, the examination and resolution of issues on a partner-by-partner or shareholder-by-shareholder basis is extremely time-consuming and a poor use of IRS' limited enforcement resources.

I support the concept of unified partnership and Subchapter S audits and believe it is an important corollary to efforts to eliminate abusive tax shelters and reduce the practical effectiveness of playing the "audit lottery."

Improving IRS Resources

While my comments have focused upon particular provisions, I want to emphasize that the ability of IRS to use these new compliance tools will be determined by IRS' budgetary resources. The compliance tools of information reporting and new penalties require adequate staffing. Merely adding these new requirements to the law will not improve compliance.

The Administration's Fiscal Year ("FY") 1983 budget request for IRS is for a total of 88,673 positions, an increase of 3,300 positions over FY 1982. About 2,000 of these positions are slated for Examinations and Appeals. In the context of sizeable budget reductions in past years, this proposed increase falls short of meeting existing IRS needs without regard to the proposals contained in H.R. 6300 and H.R. 5829. The budget request for FY 1983 represents only a 5 percent increase in staffing over my last full year as Commissioner, 1976. From a management standpoint, it has long been understood that IRS staffing should increase by 2 to 3 percent per year just to keep up with the increasing number of returns. Obviously, such increases have not occurred. Consequently, audit coverage is projected to be only 1.67 percent in FY 1983 -- down from 2.44 percent in 1977; accounts receivable total over $20 billion; and there is a backlog of 2 years in tax litigation. While the objectives of H.R. 6300 and H.R. 5829 are laudable, increased compliance will not result if the necessary resources are not provided.

Jeopardy and Termination Assessments

In my prepared testimony, I questioned the wisdom of section 101 of H.R. 6300 which extends the jeopardy and termination authorities of IRS to essentially allow IRS to make "street grabs" of cash and other valuables. I noted that DEA has specific authority (21 U.S.C. § 881(a)(6)) to seize and forfeit drug money. This authority was provided to DEA precisely to allow DEA to strike at the profits of illegal drug trafficking. *See* 124 Cong. Rec. S17644 (daily ed. October 7, 1978) (statement of Sen. Culver). This authority is DEA's primary weapon in removal of the drug trafficker's assets. *See* Drug Enforcement Administration, *Drug Agent's Guide to Forfeiture of Assets*, 354 (1981). It is DEA's policy, however, to refer to IRS the names of suspected drug dealers and other information which will assist IRS in investigating an individual's source of income and whether violations of the tax laws have occurred. *See* FY 1983 Hearings Before the Subcommittee on The Departments of Commerce, Justice and State, The Judiciary and Related Agencies, of the House Committee on Appropriations, 97th Cong. 2d Sess., Part 7 692 (1982) (statement of Francis M. Mullen, Jr.).

As I pointed out in my testimony, the courts have struck down use of the jeopardy and quick termination authorities for purposes other then enforcement of the tax laws. The Fifth Circuit has stated the position most clearly:

> The IRS has been given broad power to take possession of the property of citizens by summary means that ignore many basic tenets of pre-seizure due process in order to prevent the loss of tax revenues. Courts cannot allow these expedients to be turned on citizens suspected of wrongdoing -- not as tax collection devices but as summary punishment to supplement or complement regular criminal procedures.

Willets v. Richardson, 497 F.2d 240, 246 (1974).

The most effective way to take advantage of IRS' interest in the large amounts of cash involved in drug trafficking is for DEA to identify the suspected drug traffickers and refer them to IRS for investigation. IRS tax fraud investigators are not trained for and should not be encouraged to participate in "street busts." Moreover, since the Administration's FY 1983 Budget proposes no additional positions in tax fraud investigations, the resources do not exist to allow use of IRS agents in the front line of drug enforcement.

I appreciate the opportunity to submit these additional comments and hope they are helpful to the Committee.

Sincerely,

Donald C. Alexander

Mr. RANGEL. Thank you, Mr. Alexander.
Mr. Ferguson?

STATEMENT OF M. CARR FERGUSON, ESQ., FORMER ASSISTANT ATTORNEY GENERAL, TAX DIVISION

Mr. FERGUSON. Thank you, Mr. Chairman.

I am Carr Ferguson, an attorney at law practicing in New York and Washington. I appear at your invitation solely in my personal capacity. My interest in the proposals contained in the bill is perhaps sharpened by my background as Assistant Attorney General in charge of the Tax Division of the Department of Justice in the last administration and my years as a professor of law teaching in the area of tax procedure.

I very much appreciate your invitation to participate in your consideration of the provisions of H.R. 6300. The revenue burden of coping with mushrooming budget deficits and the national epidemic of taxpayer protest in its many forms make it imperative that all taxpayers be reassured of everyone's compliance with our self-assessment system.

That seems to me to make necessary the discharge of two basic responsibilities: On the side of government, a clear and fair direction and administration of the law; and on the taxpayers' side, full and prompt disclosure of the data that is necessary to compute tax liability.

I think H.R. 6300 is an excellent and much-needed bill which moves us in the direction of achieving both of these major themes. Like the Dole-Grassley bill, H.R. 6300 seeks to improve compliance through expanding withholding and information reporting, establishing new penalties against recalcitrant taxpayers and those assisting them, and increasing interest on unpaid taxes to a near-market rate.

But H.R. 6300 goes beyond Dole-Grassley in streamlining the summons procedures for IRS agents and permitting summary seizure and assessment of cash accumulations, and improving the Service's access to data relating to foreign activities and substantial underpayment of tax.

H.R. 6300 is an important advance in this Committee's efforts to assure that the tax burden is equitably borne and that the confidence of the public in the tax system is maintained. I would like to comment very briefly on just a few of the important aspects of the bill which perhaps might be improved.

First, I would like to associate myself with Don Alexander's observations with respect to section 101. This extension of the Commissioner's drastic powers of termination of the tax year and the jeopardy assessment power seems fashioned to involve the Service once again in drug raids and other enforcement activity of essentially nontax crimes.

The wisdom of thus diverting Service personnel is questionable, and its effect on the Service, given our experience with similar episodes several years ago, would seem not to advance the cause of taxpayer compliance, which ought to be the chief aim of the bill.

Sections 131 to 133 of the bill are very welcome improvements in the Service's summons power with respect to financial records in the hands of third parties. Section 131 would require that the taxpayer begin a court proceeding in order to quash a summons served upon a third party recordkeeper, thus reversing the discouraging delay and redtape of current law, which requires the Service to commence judicial enforcement of the summons.

Section 132 would require third party recordkeepers to assemble requested records upon receipt of a summons and to be prepared to produce such records promptly on a specified date. Under current law, third party recordkeepers frequently do not begin to respond to a summons until 2 weeks have gone by, and if a taxpayer chooses he can usually prevent compliance for months.

Finally, section 133 would provide a clear test replacing the current confusion and delay in the lower courts in the wake of the La Salle National Bank opinion as to whether an IRS summons may properly be used in the case of a matter which may be referred for criminal prosecution to the Department of Justice.

Each of these summons enforcement provisions simplifies and expedites the use of summonses. Passage of these new rules would go far, I believe, to speed up audits and fraud investigations and could well reduce the undesirable increase in the number of requests by the Service for grand jury investigation of matters more efficiently and fairly resolved administratively.

To assure that delays in summons enforcement are kept to a minimum, however, I believe the bill should go further and make it clear that judicial stays of enforcement should be available only under extraordinary circumstances.

Section 201 of the bill contains provisions designed to improve information reporting of interest, dividends, charged tips, and other items. These provisions represent a step forward, particularly as they permit the Commissioner to require submission of the data in machine readable form. However, it would be much more effective, I believe, to require withholding of tax from those upon whom the bill presently requires an information return.

For example, subject to a cost analysis and an examination of the impact of a withholding requirement upon client relationships, interest payors, brokers, and other persons hiring independent contractors or making sales to direct vendors should be required to withhold an appropriate amount of tax rather than to file information returns. With appropriate exemptions to recognize the special problems of some payors and recipients, withholding would better achieve compliance and do so more efficiently than the information reporting system contained in the bill.

It may very well be that the administration has reacted too sensitively and perhaps has overestimated resistance to withholding. My own feeling is that in the case of many pensioners, for example, withholding will be welcomed as a convenient assurance that the tax obligation has been taken care of as the year goes by.

With respect to foreign taxpayer activity, section 402 of the bill creates a new exclusionary rule of evidence by denying a taxpayer the right to introduce foreign based documents where he has failed to comply with a prior formal document request to the Service. I share the concern the bill reflects as to the need to assure timely disclosure to the Service of foreign-based books and records.

Taxpayers should not be allowed to profit by failing to keep adequate records of offshore transactions available to auditing agents. The exclusionary rule, however, places in the Service's hands a drastic and awkward power. If retained, the provision should contain a procedure for challenge and modification of unreasonable or overly burdensome document requests and for situations where the court concludes that delinquent adduction of the document advances rather than prejudices a just resolution of tax controversy.

Section 503 of the bill is, I believe, a vast improvement over section 125 of the Dole-Grassley bill. Instead of adversely affecting the relationship among tax advisers and taxpayers by requiring disclosure of return items without unquestioned support in the law, section 503 imposes a no-fault interest surcharge on substantial understatement of tax. Still, the proposed penalty will be criticized by many as creating more problems than it resolves. Indeed, it may complicate administrative settlement of audits and exacerbate what is already a confrontational polarized process. Clearer guidelines as to when taxpayers may avoid this surcharge would help respond to these criticisms. The vague provision that "the Secretary may waive all or any part of the addition to tax" seems unsatisfactory both from the standpoint of taxpayers and Government representatives.

The Service, after all, is not an impartial forum, and revenue agents are not judges to be relied upon for unbiased subjective decisions as to whether the penalty should apply.

Perhaps a better test is suggested by the standard in section 6651 of the Code, which imposes a civil delinquency penalty unless the delinquency in the filing or payment is due to reasonable cause and not to wilfull neglect. Admittedly, the case law which has developed under section 6651 is not entirely germane to the substantial understatement problem, but I think it would assure us of some useful guidelines for imposition of this penalty. If a reasonable cause defense were permitted, it might be desirable to provide that reliance upon an opinion of counsel would be reasonable cause only if the opinion concluded that the position on the return giving rise to the substantial understatement was more likely than not to prevail.

The distinction which must be drawn in applying any such penalty is between good faith errors of law or fact on one side and overly optimistic or aggressive positions on the other. It is not an easy line to draft. An alternative approach to the audit lottery problem may be more administrable and equitable. Rather than extending the list of civil penalties, Congress may prefer to encourage the Service to develop specific questions on tax returns designed to alert examiners to potential return problems.

The scope and variety of the provisions of H.R. 6300 defy comprehensive listing in the brief time available. Let me close, though, with just one more thought. I applaud the drafters for their undertaking and their accomplishment. Potentially, this is the most important tax bill of this Congress. Its aim is nothing more or less than shoring up taxpayer compliance and morale. Our self-assessment system is still a source of wonder and envy in many other countries. It is a national resource of enormous value and resilience. This bill should strengthen and preserve it. As work on the bill progresses, I am confident it will do so.

I offer whatever assistance I can provide to you and your staff to help achieve the bill's high purposes. Thank you.

[The prepared statement follows:]

STATEMENT OF M. CARR FERGUSON, ESQ. MEMBER OF NEW YORK AND DISTRICT OF COLUMBIA BARS

Thank you for the opportunity to participate in your consideration of the provisions of H.R. 6300 (Tax Compliance act of 1982"). The revenue burden of coping with mushrooming budget deficits and the national epidemic of taxpayer protest in its many forms make it imperative that all taxpayers be reassured of everyone's compliance with our self-assessment tax system.

H.R. 6300, like S. 2198 and H.R. 5829, seeks to improve compliance through expanding withholding and information reporting, establishing new penalties against recalcitrant taxpayers and those assisting them, and increasing interest on unpaid taxes to a near market rate. Moreover, H.R. 6300 goes beyond S. 2198 and H.R. 5829 in streamlining summons procedures for IRS agents seeking necessary financial data in the hands of third parties, permitting summary seizure and assessment of cash accumulations, improving IRS access to data relating to foreign activities and substantial underpayments of tax and enacting other provisions also aimed at improving taxpayer compliance. In general, H.R. 6300 is an important advance in this Committee's efforts to ensure that the tax burden is equitably borne and that confidence in the tax system is maintained. I would like to comment briefly on some of the aspects of the bill which might be improved.

Section 101 of H.R. 6300, containing proposed new Code Section 6867 ("Presumption of Jeopardy in the Case of Illegal Activity Cash"), allows the Commissioner to seize and assess as taxes due funds which he believes have been derived from illegal activities. This extension of the Commissioner's drastic powers of termination of the tax year and jeopardy assessment seem fashioned to involve the Service in "raids" furthering enforcement of essentially nontax crimes. The wisdom of thus diverting Service personnel is questionable and its effect on the Service, given our experience with similar episodes several years ago, would not advance the cause of taxpayer compliance. At the least, the provision should be modified to include a base figure below which the Section would be inapplicable.

Sections 131–133 of the bill are welcome improvements of the Service's summons power with respect to financial records in the hands of third parties. Section 131 would require that a taxpayer begin a court proceeding in order to quash a summons served upon a third-party recordkeeper, thus reversing the discouraging delay and red tape of current law which requires judicial enforcement of such summonses. Section 132 would require third-party recordkeepers to proceed to assemble requested records upon receipt of a summons and to be prepared to produce such records on the specified date. Under current law, third-party recordkeepers generally do not begin to respond to a summons until 14 days after its receipt and, if a taxpayer chooses, he usually can prevent compliance for months. Finally, Section 133 provides a clear test, replacing the current confusion and delay in the lower courts in the wake of the *LaSalle National Bank* opinion, as to whether a summons may properly be used in a case that may be referred to the Attorney General for criminal prosecution. Each of these provisions simplifies the use of summonses and makes such use more expeditious. Passage of these new rules would go far to speed up audits and fraud investigations and could well reduce the undesirable increase in the number of requests by the Service for a grand jury investigation of matters more efficiently and fairly resolved administratively.

Section 201 et seq. of H.R. 6300 contains provisions designed to improve information reporting of interest, dividends, charged tips and other items. These provisions represent a step forward, particularly as they permit the Commissioner to require submission of the data in machine-readable form as Section 214 provides. Still, it would seem more effective to require withholding of tax from those upon whom the bill presently requires an information return. For example, subject to a cost analysis and to an examination of the impact of a withholding requirement upon client relationships, interest payors (Section 201),[1] brokers (Section 202) and persons hiring independent contractors or making sales to direct vendors should be required to withhold an appropriate amount of tax rather than to file information returns with the Revenue Service and the payee. With appropriate exemptions to recognize the special problems of some payors and recipients, withholding would achieve much better compliance more efficiently than the information reporting system.

---

[1] A withholding requirement in the case of banking organizations may shift the incidence of tax by decreasing the amount of funds available for lending, and thus lending income.

With respect to foreign taxpayer activities, Section 402 of the bill creates proposed Code Section 982(a), which would establish an exclusionary rule of evidence by denying a taxpayer the right to introduce foreign-based documents where such taxpayer has failed to comply with a prior formal document request of the Revenue Service. I share the concern the bill reflects as to the need to assure timely disclosure to the Service of foreign-based books and records. Taxpayers should not be allowed to profit by failing to keep adequate records of off-shore transactions available for auditing agents. The exclusionary rule, however, places in the Service's hands a drastic and awkward power. If retained, the provision should contain a procedure for challenge and modification of unreasonable or overly burdensome document requests and for situations where the court concludes that delinquent adduction of the document advances, rather than prejudices, a just resolution of a tax controversy.

Section 503 of H.R. 6300 is a vast improvement on Section 125 of S. 2198 and H.R. 5829. Instead of adversely affecting the relationship among tax advisers and taxpayers (and taxpayers and the Service) by requiring disclosure of return items without unquestioned support in the tax law, Section 503 imposes a no-fault interest surcharge on substantial understatement of tax. Still, the proposed penalty will be criticized as creating more problems than it solves. It may complicate administrative settlement of audits and exacerbate what is already a confrontational, polarized process. Clearer guidelines on when taxpayers may avoid this surcharge would help respond to these criticisms. The vague provision that "the Secretary may waive all or any part of the addition to tax" seems unsatisfactory, both from the standpoint of taxpayer and government representatives. The Service is not an impartial forum, and revenue agents are not judges to be relied upon for unbiased, subjective decisions as to whether the penalty should apply. Perhaps a better test is suggested by the standard in Section 6651 of the Internal Revenue Code, imposing a civil delinquency penalty, unless the delinquency in filing or payment is "due to reasonable cause and not to willful neglect."

Admittedly, the case law which has developed under Section 6651 is not entirely germane to the substantial understatement problem, but it would assure us of some useful guidelines for imposition of the penalty. If a reasonable cause defense were permitted, it might be desirable to provide that reliance upon an opinion of counsel would be reasonable cause only if the opinion concluded that the position on the return giving rise to the substantial understatement was more likely than not to prevail. The distinction to be drawn in applying such a penalty is between good faith errors of law or fact on one side and overly optimistic or aggressive positions on the other. It is not an easy line to draft. An alternative approach to the audit lottery problem may be more administrable and equitable. Rather than extending the list of civil penalties, Congress may prefer to encourage the Service to develop specific questions on tax returns designed to alert examiners to potential return problems.

The scope and variety of the provisions of H.R. 6300 defy comprehensive listing, much less discussion in the brief time available to me. Many of its other proposals are of equal or greater significance than those I have mentioned and no doubt will be addressed by other witnesses. Let me close with one more thought. I applaud the drafters for their undertaking and accomplishment. Potentially, this is the most important tax bill of the Congress. Its aim is nothing more or less than shoring up taxpayer compliance and morale. Our self-assessment system is still a source of wonder and envy in many other countries. It is a national resource of enormous value and resilience. This bill should strengthen and preserve it. As work on the bill progresses, I am confident it will do so. I offer whatever assistance I can provide to you and your staff to help achieve the bill's high purposes.

Mr. RANGEL. Thank you, Mr. Ferguson.

Mr. Conable?

Mr. CONABLE. I do not have any questions. I am sorry to have missed part of your testimony. We are in and out a good deal today, as usual. I will read it with considerable interest. Thank you.

Mr. RANGEL. Mr. Duncan?

Mr. DUNCAN. I have no questions.

Mr. RANGEL. I want to thank the former Commissioners for having the political courage to try to identify income and for encouraging us to do the political impossible as it relates to withholding. Oh, I did not see you sitting there, Mr. Guarini. Do you have any questions?

Mr. GUARINI. I just have one parenthetical question. As an aside, realizing the troubles we have with compliance, from your experience in the past—and no one has had more experience than perhaps the three of you with regard to the administration of the IRS rules—do you find philosophically you are moving toward a flat tax instead of having the complicated code that we have, where the report would be on a simple small piece of paper, and that there would be no complications of tax shelters and "Chapter S's" and everything else? I really feel that it is time we have a national dialog.

Mr. KURTZ. If I may, Mr. Guarini, I would like to sort out two different thoughts that are contained in your statement. One is a simple tax and the other is flat rate. They are two separate concepts. One can substantially simplify the present tax system by eliminating many of the deductions, by taxing all income the same, et cetera, and still retain progressivity in the system. That is, you wouldn't have the degree of progressivity in rates that you have now, but you would have a much broader base, and the rates would be flatter, but it is not essential to achieve greater simplicity to flatten the rate completely. I think there is a sense in this country, a philosophical sense, that those who are much better off economically ought to make a proportionately greater contribution to the Government, and that is in no way inconsistent with vast simplifications in the tax system.

If you look at a 1040 tax return, taking that as being what most people face, you will see that most of the lines on the return are for deductions and credits, designed to encourage people to do one thing or another or compensate them for doing one thing or another, and have very little to do with the computation of their income in an economic sense or in the sense that an accountant thinks about income. Certainly almost all the deductions and credits could be eliminated and the rates could be drastically lowered, but I would not want to say that that is the same thing as a flat rate.

Mr. GUARINI. But you would be for a streamlining of our entire code?

Mr. KURTZ. Anyone who has ever had even a little finger in tax administration must favor that.

Mr. GUARINI. Mr. Alexander, you are the Commissioner of paperwork or whatever the title is.

Mr. ALEXANDER. I had two little fingers in the dike which was crumbling at that particular time.

I agree, the tax system is called on to do far too much, and because it reflects this effort to do too much, we have an incredibly complicated system that is very difficult for people to understand, difficult for people to comply with, and difficult to administer and enforce, and we need to change that.

Now, if we had our choice of keeping some graduated rates on a much broader base, eliminating the preferences, eliminating the statutory loopholes, of which there are many, and trying to have a true definition of what should be considered income, and cutting out the special deductions and special credits, I would favor having, retaining some graduated rates. If we cannot do this job without having a single rate, I would prefer to have a single rate and a broader base with a high exemption than having the mess that we have now.

Mr. **Guarini**. You would like to see some progression, but yet the truly rich, the ones at the top with all their tax shelters, the oil depletion allowances and everything else, it has been proven, pay even less than perhaps those that are in the upper middle instead of the ones who are really the wealthy people of our country. I am sure Armand Hammer pays very, very little income tax.

I just wonder if progression falls off at a certain point where the ones that have all of the money go into foundations and don't pay a damned cent of income tax. The progression works against them.

Mr. **Alexander**. I think that progression does fall off and has fallen off. I do not have access to current figures, but as I recall when I was last in office, the so-called top bracket taxpayers were generally not in the top bracket at all because they were engaged in the use of all these incentives that we have built into our system.

Mr. **Guarini**. And they can afford the attorneys and tax specialists that could show them the way.

Mr. Ferguson, in the moment I have left, do you have an opinion on that also?

Mr. **Ferguson**. I share the views which have been expressed. I think that our income tax is too valuable to this country to scrap. It better reflects the ability of each citizen to pay than any other tax yet devised. It also makes each citizen more conscious of his financial responsibilities to the Government than any other tax we pay.

Unfortunately, it is close to shambles. In large part, this is due to the power of various industries to create exceptions and loopholes. To close these loopholes this committee must overcome the power of representatives of industry to protect themselves. If you can do that, and broaden the tax base, all three of us would applaud those efforts and do what we could to support them Whether the rate is a flat rate or a progressive rate is a secondary question. I think all of us would certainly prefer a progressive income tax, but the more important and politically more difficult task is to broaden the tax base to truly reflect income.

Mr. **Guarini**. I thank you, sir.

Just as a comment, I think that perhaps an ad hoc committee of all former Commissioners would be helpful to this committee and to the Nation as a whole.

Thank you.

Mr. **Rangel**. Have any of you drafted your own ideal tax bill or supported any model legislation that supports the ideas that you have just testified to?

Mr. **Alexander**. I think I am the oldest one here, but I was too young to draft the 1913 act.

Mr. **Rangel**. But in connection with your response to Mr. Guarini in having a progressive and yet easier method.

Mr. KURTZ. I have not drafted such a bill, but many efforts that have been made, and obviously views differ widely as to various bits and pieces of it, but it is not an impossible task.

Mr. RANGEL. I just thought maybe you could——

Mr. FERGUSON. Mr. chairman, I have. I was asked by another taxing jurisdiction to draft a simplified Internal Revenue Code.

Mr. RANGEL. Could you share it with us?

Mr. FERGUSON. I would be glad to make it available. I must say to you that the jurisdiction, once they received the bill, found it was impolitic even to introduce into their legislature.

Mr. RANGEL. I can understand that.

Mr. FERGUSON. But if you would like to have it, I still have a copy of it.

Mr. RANGEL. At least our conscience would bother us less.

Mr. CONABLE. Would the Chairman yield?

Mr. RANGEL. Mr. Conable.

Mr. CONABLE. I know you are a sophisticated group, but I cannot believe you are serious about this. Maybe I have been here too long, but you put in a simple tax bill and this body will so politicize and compromise it that by the time it gets passed it will no longer be a simple tax bill. We ought to focus on a few things addressed to making the tax law do what it says it does.

Now, in fact, the tax law does a lot better than most people think because the last figures I saw showed that people with adjusted gross incomes of over $200,000 in fact paid 59 percent of their adjusted gross in taxes. But of course, what a phoney figure that is, too, because we do not even have any way of knowing who owns tax-exempt bonds, the ultimate refuge.

Admittedly, tax-exempt bonds have a function, but we ought to start with a few simple things like that, trying to identify who owns what and how they use it in tax terms. I will tell you that if we go to a 17-percent tax, to me that means probably that everybody below 17 percent gets a tax increase, and everybody above 17 percent gets a tax reduction.

We talk about this as though it were such a pious, wonderful idea. If Ronald Reagan proposed it, everyone would say he is trying to favor the rich, and they would be right because such a proposal would favor the rich unless it were phrased in some complicated way with a high threshold and a whole lot of exemptions and exclusions that would make it a great deal less than a simplifying tax.

Jimmy Carter was in favor of simplifying the tax law, and he apparently failed to understand that three out of four taxpayers are on the short form to begin with, and that is a sobering fact. The people making $60,000 a year are those who think it would be so great to have a simple tax, and it would be great for us to have a simple tax.

But you know, I just cannot get over the drive for a simple tax at this point, convinced as I am that by the time a simple tax was put in legislative language it would be virtually incomprehensible, as is the tax law that we have evolved over the years.

Excuse me for interjecting my views.

Mr. RANGEL. None of the witnesses have indicated that they supported the flat tax rate, but I enjoyed your remarks anyway.

Mr. CONABLE. Thank you. Thank you, Charlie. If I have provided just a little comic relief in the day, I am only too grateful.

Mr. RANGEL. Let me ask Commissioner Alexander, you seem to get quite upset with these provisions as they relate to criminal activity and the presumption of ownership. I want to make it abundantly clear that I do not see how we can ask the IRS to enforce the violations of the Federal narcotics laws, when it appears today that they are receiving fewer resources to tackle an ever-increasing problem.

I notice the emotion that is sometimes displayed as it relates to criminal activities and what is asked of the IRS when large amounts of cash are found or deposited. I do not see where that same concern is found when a regular taxpayer comes up with extraordinary amounts of money, where if you do not have presumptions, they certainly have a lot of explaining to do as to where the money came from, where it was deposited.

It just seems to me that what is in section 6867 and 6868 are not extraordinary provisions.

Could you tell me specifically what it is that you believe is an abuse of the IRS principles there?

Mr. ALEXANDER. I suppose part of the problem is not so much what the provisions say but how they will be used. The provisions will be interpreted as an invitation for IRS to replace DEA as the——

Mr. RANGEL. I will try to do all that I can to get the language that enforcement would feel comfortable with, but my problem is and you well know it, people with no legitimate source of income that own three or four foreign cars, that own several homes, that live far above the means of anyone in the community. The IRS know exactly who they are. The local police know who they are. The DEA know who they are. We are saying that when they drop $10,000 or $15,000 around in the apartment, and it is picked up, you make certain presumptions.

Mr. ALEXANDER. I think you should make a special effort, and I think the effort should go well beyond the treatment of ordinary taxpayers, and I believe that it has gone well beyond that effort.

Mr. RANGEL. What is it that is said here, former Commissioner, that you do not like? Are you saying that you do not trust the agents as to how they will enforce what is done here?

Mr. ALEXANDER. I think the agents are worthy of trust.

Mr. RANGEL. Or that they will be overzealous?

Mr. ALEXANDER. One of the problems is the use of the word "recently," "recently deposited." If we want to get into technicalities of this, I will be glad to submit a further statement.

Mr. RANGEL. Would you do that because I do not care when——

Mr. ALEXANDER. One of the dictionary definitions in Websters International is anything since the ice age.

Mr. RANGEL. I do not have any problem with that definition. If there are large sums of money that have been deposited by someone that has no obvious legitimate source of income and they cannot explain where the money came from, I do not have any problem unless there are legal problems in making certain presumptions.

Mr. Alexander. I think that no one surely at this table or in the room would be in favor of exempting drug traffickers and other people engaged in various professions from the tax system. Far from it. The question is how are you going to cope with your responsibility in trying to define the responsibility and trying to fulfill it in an efficient and an effective way? The efficient and effective way is for the DEA to try to identify these people and IRS then to investigate them, and in the very situation you described, someone that wealthy, surely IRS has a duty to investigate them.

Mr. Rangel. OK, that is fair enough.

In other words, you would want to see the initial responsibility for identification to be with the law enforcement agency, but you have no problem with the provisions of IRS responsibility.

Mr. Alexander. I have no problem with the concept. With the particular wording of the provision I would like to submit a further statement to you.

Mr. Rangel. I will look forward to it.

My last question, many people that are trying to attack the drug trafficking problem have suggested that we call in all large denominations of currency and ask people to turn it in to the local banks and issue new currency, either lower in denomination or a different color. The idea is that many criminals will never be able to come forward to the banks with it and we could balance the budget.

Have these ideas come across your desk when you were Commissioner?

Mr. Kurtz. I think that is an idea, Mr. Chairman, that comes up about every 2 years and has since the Second World War. It comes up at the Treasury Department. The problem with it is—and I assume it is a problem that is not insurmountable, but the problem with it is the huge number of large bills that are outstanding and whether, in fact, the financial institutions of this country could manage such an exchange in any reasonable way.

There are also problems, of course, with bills that are overseas, that do not represent the results of illegal activity but which are not readily available to be returned.

There are a range of problems. This has been studied. I am sure, Mr. Chairman, if you go back to the Treasury Department, they can produce papers on this that have been done from time to time.

Mr. Rangel. Thank you very much.

I thank all of you.

Mr. Guarini. Mr. Chairman, I just want to ask one last question. You have talked about withholding before on money going overseas so that if money is made in active income, we would retain a 30 percent withholding tax on the money sent to a foreign source. We do nothing with regard to capital gains, do we?

Should we?

Mr. Kurtz. You do in the case of real estate. The Foreign Investors in Real Property Tax Act passed several years ago, it levies a tax.

Mr. Guarini. We require them to pay, but do we actually withhold, because once the money goes, you will never get it back. But yet with money that is paid for interest or from rents and royalties or something of that sort, if it is not a treaty, we withhold 30 percent.

Mr. KURTZ. There are two questions. One is whether the gain is taxable in the first instance. That is, a nonresident alien not engaged in trade or business in the United States who has a gain on a U.S. security is not subject to U.S. tax at all. Withholding would be a substantive change.

Mr. GUARINI. Right, but where there is a tax——

Mr. KURTZ. Rather than an enforcement change.

Mr. GUARINI. Where we have a tax on income, we do withhold 30 percent on that income.

Mr. KURTZ. But it is only on specific types.

Mr. GUARINI. Obviously providing it complies with treaties, etc. But where we have many people in Japan and in France and Switzerland that are buying large tracts of land and they sell it for millions of dollars, we send that money out without any withholding tax, do we not, if there is a capital gain?

Mr. KURTZ. That is right.

Mr. GUARINI. We require them to pay it, but how do we collect it?

Should we address ourselves to that problem because there are more people buying real estate and large apartment buildings and farms and vineyards in our country now than ever before.

Mr. ALEXANDER. As Mr. Kurtz stated, we attempted to deal with this in the Foreign Investment in Real Property Tax Act of 1980 [FIRPTA], but clearly the best way to collect the tax under those circumstances is to withhold it, rather than to attempt to collect it from a nonresident alien at a later time.

Mr. KURTZ. My recollection is an earlier version of that bill, FIRPTA did have withholding in it.

Mr. FERGUSON. An earlier version of the FIRPTA bill had a provision to impose a lien on the U.S. real property, which would seem to me quite a good idea. I think it was dropped out later on.

Mr. GUARINI. As I remember, I think it required, put a responsibility on the person who was the party to the transaction, but it did not withhold any money whereas we do it to protect ourselves with income but we do not do it to protect ourselves with any capital gains overseas. That is just a thought.

Thank you.

Mr. RANGEL. Thank you very much.

The American Bar Association, John S. Nolan, chairman of the section on taxation; the American Institute of Certified Public Accountants, Douglas Banks, member, Subchapter K Task Force, Federal Tax Division.

Mr. Nolan, you may proceed.

STATEMENT OF JOHN S. NOLAN, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. NOLAN. Mr. Chairman and members of the committee, my name is John S. Nolan. While I presently serve as chairman of the section of taxation of the American Bar Association, the very short time since H.R. 6300 has become available has made it impossible to obtain official positions of this section or the association on most of the major elements of H.R. 6300. This is very unfortunate. This is an extremely important bill which would make extensive changes in well-established practices in tax administration. Most of its provisions are well-conceived, but there are serious deficiencies in some areas in carrying out the objectives. This is particularly the kind of tax bill as to which the views and experience of the practicing tax bar are needed.

This bill will have substantial effects on the rights of taxpayers and will go to the heart of the public perception of fairness in our tax system. This public perception of fairness supports the entire voluntary compliance nature of our self-assessment tax system, and we must be certain that we proceed carefully to increase the public perception of fairness rather than to diminish it. Many of the problems I see in this bill could be cured by dynamic interaction between the congressional staffs, the Treasury Department, and private tax experts acting through their professional associations, such as the American Bar Association and the American Institute of Certified Public Accountants. I urge you to provide this opportunity, before you act on this bill.

I will submit a detailed written statement as to all of the provisions of H.R. 6300 for the record later today. For the most part these are solely my personal views. I have, however, benefited over the last few days from an exchange of views with many tax experts on the specific provisions of the bill. The tax section held its annual spring meeting in Washington over this past weekend, and H.R. 6300 was the subject of intensive study and debate.

I can speak for the tax section in strongly endorsing the third party summons provisions in sections 131 and 132 of H.R. 6300. These provisions were contained in prior bills which we considered and approved. They will greatly improve the effectiveness of third party summons in the hands of the Internal Revenue Service without depriving taxpayers of any legitimate rights. I also speak for the entire American Bar Association in strongly endorsing section 215 of H.R. 6300 which would exempt rules and regulations under the Internal Revenue Code from the Paperwork Reduction Act of 1980. For reasons set forth in my written statement, tax regulations and forms need not be subjected to OMB review and are not within the essential purposes of the Paperwork Reduction Act. This is a very important matter.

Otherwise, as I have said, my views do not represent the position of any organization and are solely my own. I question the wisdom or soundness of the provisions of part 1 dealing with jeopardy assessments with respect to cash transactions. The section of taxation if developing useful suggestions in this area, and they will be available to you very soon. I support section 102 of H.R. 6300 requiring all government and corporate obligations of a type issued to the public to be in registered form.

I endorse the new frivolous return penalty in section 123. Otherwise, however, I have serious reservations as to many of the new penalty provisions in this bill. I agree that in concept some penalty directed at promoters of abusive tax shelters is necessary and appropriate, but the provisions of section 111, and the new injunction proceedings provision in section 112, require considerably more study.

Also, there are better alternatives to the increase in the fraud penalty in section 121, as described in my statement. The penalty for documents understanding tax liability is poorly conceived and highly dangerous to good tax administration; I propose specific alternatives. The interest surcharge on substantial understatement of tax is equally badly conceived and dangerous and should be fundamentally reconsidered.

We must be extremely cautious in adopting new penalties. They cannot ever substitute for increased voluntary compliance, and if the tax law moves toward a catch-me philosophy, as in some foreign countries, public confidence could be undermined and the compliance gap could increase still further. We cannot solve the noncompliance problem in any significant degree by simply throwing new penalties at it. Several important new penalties and other measures to increase compliance were enacted in the Economic Recovery Tax Act of 1981, and as to some of these new penalty proposals, it may be better to await experience with what has already been done.

I support the new administrative summons proposals in section 133 of H.R. 6300. They seek to establish a bright line, a clear point in time up until which a summons may be used by the IRS, but not thereafter because the investigation has shifted to a criminal prosecution purpose. Taxpayers' rights, in general, are protected in these provisions, although I suggest some technical improvements in my statement.

I strongly support the new information reporting requirements in sections 101 and 102 with respect to payors and interest and brokers in securities, commodities, and other transactions.

I also support section 203 dealing with information reporting as to payments to independent contractors, particularly in the door-to-door sales area, but I urge that they do not substitute for a comprehensive examination of the employee independent contractor problem by this committee in the near future. The committee should determine the extent to which safe-harbor rules clarifying the position of certain groups as employees or independent contractors are appropriate. The committee should also consider the extent to which withholding on repetitive payments by a business payor to an individual rendering services should be imposed even though such person may be an independent contractor by common law standards. The determination whether withholding is appropriate should not be based upon common law rules developed long before the income tax system to resolve tort liabilities. It should be determined by the administrative feasibility and need for withholding in light of the degree of continuing relationship between the parties and the extent to which repetitive payments are made by the payor to the payee.

I question the need or utility of the proposed new information reporting requirements as to State and local income tax refunds and casualty reimbursements. They will impose significant costs on society, and a cost-benefit analysis is very much needed here.

I strongly support the new provisions as to failure to file information returns or supply identifying numbers. I particularly recommend the new withholding provisions where a taxpayer fails to supply his number or supplies an incorrect one. I raise some questions in my statement as to section 214 dealing with supplying information returns on magnetic tape.

I support the provisions of section 301 as to information reporting and voluntary withholding with respect to pension and annuity payments. I make some suggestions for improvement in my statement. I particularly urge that the effective date provisions for these new requirements be modified.

I oppose many of the provisions of part IV of H.R. 6300 dealing with transactions outside the United States. The objectives of these provisions to some extent confuse the treatment of illegal activities and legitimate business operations regularly conducted in foreign countries by U.S companies.

Section 401 establishing venue for summons enforcement actions as to persons outside the United States is well conceived but needs further study. Section 402 denying the admissibility in court of foreign books and records if they have not been produced for the IRS in the audit process is severely deficient and even raises serious constitutional problems. While there is a problem to be addressed in this area, even as to legitimate foreign business operations, the matter requires a great deal more study. I have similar, fundamental concerns as to the presumptions that foreign connected amounts are income. There are serious dangers of infringement of taxpayers' fundamental rights in these provisions. The provision for maintenance in the United States in some instance of foreign books and records is well conceived but needs more development.

I support the new provisions for semiannual changes in the interest rate on deficiencies and refunds based on a 6-month average. These are very well conceived. While I support some compounding of the interest, I cannot support the daily compounding proposed in H.R. 6300. This will be widely perceived by the general public as unfair; it is not the way that interest on loans is determined in the marketplace. I suggest semiannual compounding only, and even then only after the first 3 years.

I strongly oppose section 502 of H.R. 6300 denying interest on refunds attributable to carrybacks until the due date of the return is extended for the year in which the carryback arises. This is quite unfair. In addition, it creates very undesirable pressures on corporations to rush the filing of their returns to avoid loss of interest. This could do severe harm to the administrative process both from the standpoint of the IRS and the taxpayer. At the very most, interest should be denied only for the period, if any, by which the claim for refund is filed after the due date of the return is extended, and even then not if the carryback arises as a result of an IRS audit adjustment. A full analysis of the problem is contained in my statement.

I am pleased to be able to conclude on a very positive note. I strongly endorse part VI, providing for centralized audit and litigation in partnership and subchapter S tax matters. These may well be the most important provisions of this bill, and they are the product of an extended, careful dialog between the Internal Revenue Service on the one hand and the professional associations on the other hand. They are very well-conceived and will do much to deal with the abusive tax shelter problem. The rights of individual partners are thoughtfully and adequately protected at every stage in the proceedings. I recommend only one change, but it is a very important one. There should be an exception for small partnerships of 10 partners or less for reasons that are developed in my statement.

In conclusion, I would like only to associate myself with the remarks of former Commissioner Kurtz in stating that one of the matters that must be given more consideration by the Congress is the matter of the IRS budget and appropriations. I have appeared recently before the House Budget Committee on this score and the Section of Taxation has also appeared before the Senate, and in both cases urging that much more consideration be given to the need of IRS for additional funds in its audit process.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF JOHN S. NOLAN

INTRODUCTION

My name is John S. Nolan. While I presently serve as Chairman of the Section of Taxation, American Bar Association, I do not speak today for the Section of Taxation or the American Bar Association except as to certain specific matters which I will identify. Because H.R. 6300, which is the primary focus of these hearings, became available only late last week, it has not been possible, within the time available, to develop the positions of the Tax Section or the American Bar Association on most of the major elements of H.R. 6300. Thus, except as specifically noted, this statement does not reflect any official position of those organizations.

The Section of Taxation held its Spring Meeting over this past weekend, and I have had the benefit of discussions with many able members of the Section who are experts in the various subject matters of the bill in formulating the views expressed in this statement.

H.R. 6300 and other tax compliance bills would make major changes in many provisions of the Internal Revenue Code and in well-established practices in tax administration. These provisions of law and established practices have taken decades to establish; they are designed to protect the Government's need for revenue on the one hand and to protect the rights of the taxpayer on the other hand. While significant changes in many areas are needed to deal with the compliance gap, more harm than good to the tax system can result if these changes are not carefully thought through. I respectfully suggest that the considered views of private lawyers and accountants who work most intimately with the tax system should be a vital part of the process of insuring that the changes do not have unintended consequences which detract from or outweigh their benefits.

The time schedule for consideration of H.R. 6300 has operated to prevent the proper working of this process. Copies of the bill first became available for public distribution last Wednesday afternoon. Testimony was to have been submitted by yesterday morning -- only two full working days later. Even assuming that private experts were willing to work over the weekend, there was insufficient time for even the barest exchange of documents. Surely the development of H.R. 6300 has required many weeks, perhaps months, and critical analysis by outside experts calls for "equal time". Were it not for the fortuitous fact that the Tax Section was meeting over the weekend, it would not have been possible to obtain the considered views of more than only a very few persons in preparing this testimony.

I respectfully report for the record that the Council of the Section of Taxation at its meeting on Thursday adopted a resolution protesting and deploring the use of such procedures as to a tax bill as significant as H.R. 6300. We hope very much that, despite the pressures of the legislative process in a divided Congress, some means will be found to permit more reasoned participation by the public as to this bill and all important future tax bills.

In my testimony which follows, a number of significant questions and problems which are generated by this legislation are set forth. A number of them could be met by careful interaction between the Congressional staff and organized tax practitioners. Surely some means should be found to make this possible if the bill is to have its intended effect.

I. Crimes, Abusive Tax Shelters, Frauds

Jeopardy Assessments With Respect to Cash

Income tax can now be immediately assessed and collected if delay will prejudice the collection of the tax. Under existing law, such a jeopardy assessment is subject to Federal District Court review, in which the Government bears the burden of proving the reasonableness of the determination.

Section 101(a) of H.R. 6300 creates a presumption in two situations that certain cash items represent gross income and that collection of tax will be jeopardized by delay. Where an individual or a corporation possesses, controls, or deposits (or recently possessed, controlled, or deposited) cash which the Internal Revenue Service believes to be related to an illegal activity, or where an individual possesses $10,000 or more in cash, denies ownership, and cannot readily identify the owner of the cash, these new presumptions arise.

These provisions are intended to assist the Internal Revenue Service in the collection of tax attributable to income derived from illegal activities. While I support strong new measures to reach cash transactions, some of which are being developed by the Section of Taxation, I suggest that these particular proposals raise serious questions.

Initially, it is not clear that these provisions would actually assist the Internal Revenue Service very much in dealing with cash transactions. Although the presumption created by the bill would remove the Internal Revenue Service burden of proving that the jeopardy determination was reasonable, both situations described in the bill are already subject to jeopardy assessment. It does not appear that the Service is unable to sustain jeopardy assessments in such cases under existing law. This Committee should carefully consider whether it is desirable to presume that an Internal Revenue Service determination is reasonable to permit invocation of the extraordinary remedy represented by the jeopardy assessment procedure. Fundamental issues of fairness are presented even where cash transactions are involved.

In addition, such definitions of situations in which jeopardy is presumed could have an impact contrary to that intended. A court could view the two defined situations as limitations on the power of the Internal Revenue Service. Thus, a court could find that the Internal Revenue Service has acted unreasonably in any jeopardy assessment case in which the danger of delay in assessment does not parallel the facts in the two situations which are covered in the proposed provision.

A number of technical questions are also raised by the draft language of this provision. New Section 6867(2) would treat "gross receipts from" or "funds used in" an activity believed to be illegal as gross income. While the propriety of treating "gross receipts" as gross income may be acceptable, the treatment of all "funds used in" an illegal activity as gross income is questionable. New Code Section 6868(a)(2) treats cash in excess of $10,000 as gross income if the individual possessing the cash does not claim that the cash belongs to him or to another person whose identity can be "readily" ascertained by the Service. This standard is ambiguous, and the Committee report should attempt to clarify how it is intended to be applied. In addition, both new Code sections 6867 and 6868 would apply to a person who possesses "cash". New section 6869 defines cash to include any cash equivalent. It is unclear whether cash merely means United States currency or also includes checks. This issue should be clarified in the statutory language or committee report.

Reporting Requirements --
Money Taken Out of U.S.

Section 101(c) of the bill provides that for purposes of "any law" requiring reporting of monetary instruments in excess of $5,000 transported from the U.S. to a point outside the U.S., an attempt to transport shall be subject to the same reporting requirements that apply to an act of transporting. This provision would extend the Currency and Foreign Transaction Reporting Act (commonly referred to as the Bank Secrecy Act). This provision would not amend the Internal Revenue Code; it is to be included in the statutes-at-large. It appears to be a desirable change, but it should be considered in the context of the entire Bank Secrecy Act, not the Internal Revenue Code.

Registration of Obligations

Section 102 of H.R. 6300 generally would require all obligations of the United States (or its agencies or instrumentalities), state and local governments, corporations, and other entities to be issued in registered form. The provision would treat an obligation as being in registered form notwithstanding the fact that the right to principal and interest with respect to the obligation may be transferred through entries on the books of the issuer rather than by surrender of the old instrument and reissuance.

The requirements of this provision are enforced by: (1) denying income tax exemption with respect to the interest on any state or local obligation which is issued after the effective date and is not in registered form; (2) denying an interest expense deduction to the issuing entity with respect to an obligation which is issued after the effective date and is not issued in registered form; and (3) denying any loss deduction to the holder of an unregistered obligation issued after the effective date.

This provision is appropriate, and its enactment would materially assist the Internal Revenue Service in the collection of income, estate and gift taxes. It would deny opportunities under existing law to conceal income and net worth through investments in "bearer" obligations. Further, the "book entry" rules in the provision are well conceived and should reduce the administrative burden (and associated costs) arising from the transfer of the principal and interest on such obligations.

Abusive Tax Shelters

Sections 111 and 112 of H.R. 6300 deal with promoters of certain tax shelters which are labelled in the bill as "abusive". Section 111 creates a penalty for making or furnishing a false statement or a gross valuation understatement in connection with a tax shelter. Section 112 permits the Internal Revenue Service to seek an injunction against a violation of section 111 to prevent recurrence of such conduct.

The objectives of these new provisions are generally meritorious. Furthermore, since there are no present penalty provisions in the Internal Revenue Code directed at tax shelter promoters or abusive tax shelters, it may be neither repetitive nor cumulative to add such a penalty to the Internal Revenue Code. The injunction would permit the Internal Revenue Service to move against egregious violations years earlier than is presently possible. A few well-chosen actions could dry up a significant number of the worst shelters.

Unfortunately, the provisions as presently drafted need much more consideration. My concerns are sufficient to raise a serious question whether any such provisions should be enacted without a great deal more serious study.

The penalty could be applied, and the injunction provisions could become applicable, if there is a "gross valuation overstatement", defined as one in which the value of property or services described is 200% or more of the "correct" value and is directly related to the amount of any deduction or credit allowable to an investor. This would be determined without regard to the materiality or insignificance of the overvalued item. If, for example, a real estate partnership pays $7500 for tax deductible services which the Internal Revenue Service contends were worth only $3000, it could invoke these extraordinary provisions even though that deduction, taken alone, is not material to the transaction.

I suggest that at the very least, the provision be limited to cases where the gross valuation overstatement or the false or fraudulent statement as to a tax benefit relate to a "material tax benefit" arising out of the organization of the partnership or other entity, or investment plan or arrangement, which has been prominently referred to in offering or sales promotion materials to induce other persons to invest in such partnership or other entity, or investment plan or arrangement.

It has been suggested that the penalty should not be applicable if the accuracy of a valuation is specifically disclaimed in the offering and other sales promotion materials. Without personally endorsing this suggestion at the present time, I do suggest that the matter be given further consideration.

In the case of funds pooled for investment in research and development projects, or in other transactions in which the subject matter is technologically innovative or unique, the question of valuation is inherently very difficult. It is unwise to inhibit the use of investment funds as a source of venture capital for advanced technological development. Such investment funds are an important source of R&D development at the present time. It also would be inequitable to permit the Service to impose this penalty or seek injunctive relief merely because of a bona fide disagreement over the valuation of such inherently hard-to-value assets. The provision in the bill for waiver of the penalty on a showing that there was a reasonable basis for the valuation and that such valuation was made in good faith may not be an adequate response to this problem. The matter requires further consideration. At the very least, the Committee's report should provide sufficient explanation to insure that these provisions reach only those cases which are truly "abusive".

As the provisions are presently drafted, the "promoter" of the tax shelter includes all those who assist in its preparation and sale. This may include counsel for the partnership, counsel for the underwriter, the underwriter, and all sales persons who seek to sell units to investors, whether or not they know of the gross valuation. The penalty should apply only to persons who know or have reason to know that the valuation is a gross valuation overstatement.

A further concern as to this penalty in its present form in the bill is that it creates a potential conflict-of-interest problem as to the Internal Revenue Service. Practical experience suggests that the Service will aggressively attack the promoter on the "gross overvaluation" ground while seeking to deny the tax benefits to the investors. The Service might use the penalty to compel the promoter to make concessions adverse to the interests of the investors, or use the threat of larger deficiencies as to the investors to impose the penalty on the promoter. Many of these problems might be avoided by a penalty on the promoter which is based upon the penalties imposed and sustained as to the investors.

Additional Penalties for Fraud, Documents Understating Tax Liability, Frivolous Returns, Interest Surcharge on Substantial Understatement

The bill proposes new penalties in the form of an increased fraud penalty, (section 121) a penalty for documents understating tax liability (section 122), a penalty for frivolous returns (section 123), and an interest surcharge on substantial understatement of tax liability (section 503).

As a general matter, it seems unwise to adopt a series of additional penalties, often cumulative or overlapping, to deal with the noncompliance problem. Ultimately, penalties cannot serve as the centerpiece of the compliance effort. They reflect a "catch-me" philosophy which undermines voluntary compliance in a tax system in the United States which must of necessity remain essentially a self-assessment system. They are reminiscent of the systems of some foreign countries which do not work well. A system which depends heavily for compliance on penalties necessarily confers a wide range of discretion in enforcement, and as a result it leads to bitter controversy and gives rise to a sense of unfairness. If the penalties are not applied with uniform good judgment and discretion, they lead to mechanical application and create hardship.

This Committee should recognize that what may seem to be a good short-run idea to attack the compliance problem may be the grist of tomorrow's sensational news articles and

Congressional hearings with respect to hard cases as to the unfairness of the tax system. This is what undermines voluntary compliance in the long run and leads to do-it-yourself tax avoidance by large segments of our population.

In considering this matter, the Committee should recognize that substantial steps along these lines have already been taken in the Economic Recovery Tax Act of 1981 (ERTA). In ERTA, the negligence penalty was substantially increased. An over-valuation penalty with substantial consequences was enacted. The bill also elsewhere contains important provisions as to interest on tax deficiencies and other provisions which will encourage compliance. In the case of some of these proposed new penalties which raise serious problems, it may be advisable to await experience with what has already been done.

Increased Fraud Penalty. Section 121 of H.R. 6300 would increase the fraud penalty and make it "time sensitive" by adding to the existing penalty an amount equal to 50 percent of the interest with respect to that part of the underpayment attributable to the fraud. A preferable alternative would be that endorsed by the American Bar Association in its comments on S. 1594 in November, 1981. S. 1594 provides that the penalty would be equal to 100 percent of that portion of the underpayment attributable to the fraud, as compared to present law, which imposes a 50 percent penalty applicable to the total underpayment. The goal of making the penalty "time sensitive" can be accomplished by making the fraud penalty, as defined in S. 1594, subject to interest as of the due date of the applicable return, as contrasted with present law, under which the fraud penalty does not become subject to interest until the date of assessment.

Penalty for Documents Understating Tax Liability. Section 122 of the bill is explained as if it is intended to impose a civil penalty, corresponding to some extent to the criminal penalty under Code section 7206(2), on persons who aid or assist in the preparation or presentation of false or fraudulent documents. The bill as drafted, however, goes very much beyond that concept. It applies wherever a person aids or assists in the preparation of a return or any other document in connection with a matter arising under the internal revenue laws and knows that such document will result in an understatement of tax for another person. Thus, fraud is not an element to any extent.

In its present form the provision would impose an ill-conceived and unjustified penalty in many situations where an individual acted in good faith believing that the taxpayer's position had a "reasonable basis" even though it ultimately was not sustained. As I have stated in my testimony on a similar provision in S. 2198 (section 121), to the extent the provision would be applied to corporate officers and directors, it is questionable whether there is a need for this new penalty. Those individuals are already subject to substantial non-tax deterrents, and the proposal could produce an unnecessary chilling effect on the willingness of individuals to manage and advise corporations.

If such a penalty is to be enacted, a much preferable alternative would be to track the language of Code section 7206(2), i.e., situations in which an individual willfully aids or assists, etc. in the preparation or presentation of a return, etc. "which is false or fraudulent as to any material matter". By adopting that approach, one could be assured that a civil penalty would be imposed in those situations now subject only to criminal penalties.

If such a penalty is to be adopted, and if the foregoing alternative suggestion is not accepted, I strongly recommend that you substitute section 121 of S. 2198 for this provision with certain amendments. The ceiling on the amount of the penalty in section 121 of S. 2198, which is based on the underpayment of tax, should be far less than $100,000. That may far exceed any personal advantage gained at the individual level. A flat penalty of $5,000 or $10,000 would be more appropriate. The penalty should be limited to situations in which there is fraud, not merely an understatement of tax, and in which the person knew of the fraud, not including cases where the person "should have known". The latter standard is too vague to justify impositon of a derivative penalty. Finally, the penalty must be integrated with the tax preparer penalty as this bill undertakes to do. At most the penalty should be the greater of the penalty under section 121 of S. 2198 as amended or the penalty under section 6694 of the Code.

Frivolous Income Tax Return. Section 123 of the bill would impose a penalty of $500 on the filing of a frivolous income tax return. The so-called "protester returns" represent an intolerable burden on the administrative and judicial processes and are completely unjustified. Accordingly, I support the enactment of this penalty.

Interest Surcharge on Substantial Understatements of Tax. Section 503 would impose a surcharge equal to 20 percent of the interest with respect to an underpayment attributable to a "substantial understatement" of income tax for any taxable year. All or any portion of the surcharge may be waived by the Internal Revenue Service on a showing by the taxpayer that there was -- (1) a reasonable basis for the understatement; and (2) the taxpayer acted in good faith.

Consistent with my general comments, I am generally not in favor of enacting additional penalties which are not clearly justified or which overlap existing penalties. I strongly oppose current enactment of this specific proposal because it particularly will be viewed on a widespread basis as unfair.

Although styled as an interest surcharge, it is in fact a penalty. H.R. 6300 elsewhere goes to considerable lengths to insure that the interest rate on deficiencies and refunds is as consistent with market interest rates in comparable circumstances as is administratively feasible in the tax system. There is no rational basis for charging a higher interest rate for the use of money on large understatements of tax liability as opposed to smaller ones. Thus, the provision can only be regarded as imposing a penalty on larger tax deficiencies. The provision is even explained by reference to the no-fault penalty imposed on valuation overstatements in the Economic Recovery Tax Act of 1981.

It is objectionable to enact a penalty in the form of an interest surcharge. It improperly affects the manner in which the courts treat such a charge; if it is a penalty, it should be applied as a penalty with the inherent judicial discretion that courts use in considering the application of such a measure.

While the Explanation describes the penalty as non-deductible, nothing in section 503 itself provides that the surcharge is not deductible. The charge is described as interest but is contained among the penalty provisions of the Code. It is stated to be an addition to the tax, but this is not necessarily conclusive. Compare Code section 6601(e)(1). A court might possibly hold the penalty deductible. At the very least, this would be a source of controversy. If it is deductible because it is designated as an interest surcharge rather than a penalty, the burden will vary with the marginal tax rate of the guilty party and will depend on such extraneous factors as the existence of a net operating loss, carrybacks or carryovers from other years, or the extent of the investment credit or foreign tax credit in the taxpayer's return. This is unsound.

This provision appears to be in lieu of section 125 of S. 2198, which provided a no-fault penalty for understatements of tax attributable to items not disclosed in the return. Many of my concerns stated in my testimony and in my subsequent letter of April 16, 1982, to Senator Dole as to that provision are equally applicable here. Indeed, those concerns are even greater as to this proposal because this penalty cannot be avoided by disclosure in the tax return.

There is nothing inherently wrong or unusual in a large tax deficiency in a tax system as complex as that in the United States. Reasonable men may differ as to the meaning of the law, and the Internal Revenue Service position is frequently rejected by the courts. In many cases, particularly in business tax returns, the issues are apparent, and the Internal Revenue Service has highly-sophisticated tax return selection criteria, computer programs, and audit techniques for exposing the issues. It is common that taxpayers and the Internal Revenue Service have disagreements over items which may result in large tax deficiencies, such as inventory valuation, bad debt reserves, capitalization of costs as to self-constructed assets, amounts deducted as to repairs rather than capitalized as asset costs, reasonableness of salaries, assets qualifying for the investment credit, and others. These issues are frequently litigated; in some cases the Service prevails, but in many cases, it does not. The taxpayer may have had an entirely reasonable basis for the position taken. The taxpayer should not automatically incur a penalty in these cases simply because the Service ultimately prevails on the merits.

If some such provision is to be enacted, I urge that you substitute an amended form of section 125 of S. 2198. The key to the fair operation of the no-fault penalty in section 125 of S. 2198 is the determination whether there has been a disclosure to the Service of the item giving rise to the underpayment of tax. This Committee should provide considerably more guidance in the provision itself and in the Committee's report as to the definition of disclosed items for purposes of this penalty provision. That guidance could take both the form of a more specific description of what must be disclosed and how it must be disclosed and the form of specific examples. The meaning of "nature and amount of such item" (proposed Code section 6660(c)(1)(A) should be further explained. The standards should provide more guidance as to what will constitute adequate disclosure. Disclosure should not be limited to disclosure "in the return", or "in a statement attached to the return", if it is otherwise adequate, has all necessary identification, and is in a form that it can be readily associated with the return. Thus, for example, any informational reporting, whether by the taxpayer or by a third party, which relates to the taxpayer's tax liability for the taxable year should be deemed adequate disclosure by the taxpayer.

As previously suggested, the application of this penalty with respect to activities of a trade or business deserves more study. Underpayments attributable to highly discretionary adjustments by the IRS, the facts with respect to which are reasonably apparent on the face of the return, but as to which there is no specific disclosure in the return, present special considerations. This would include items such as inventory valuations, bad debt reserves, and others previously mentioned. The Internal Revenue Service normally looks at these items in any business return, and it is questionable whether a penalty should be imposed simply because there is no specific disclosure. These types of adjustments produce large deficiencies, but if the interest rate is adequate and the taxpayer's position had a reasonable basis, there should be no penalty.

The threshold amounts in section 125 of S. 2198 may be too low. The $5,000 amount for individuals perhaps should be $10,000 (compare section 163(d) relating to limitations on investment interest). The amount for corporations (other than subchapter S corporations and personal holding companies) perhaps should be $25,000. Alternatively, or in combination, the penalty could be made to apply only to underpayments in excess of the threshold amounts.

The penalty should only be applicable to undisclosed items which are contrary to published regulations or revenue rulings.

The penalty probably should not become applicable until adequate regulations are proposed, subjected to public comment, and finalized. Those regulations should be very specific as to -- (a) the kinds of items which should be disclosed; and (b) the manner of their disclosure. Any portion of an underpayment attributable to items which the regulations do not require to be disclosed should not be included in the base for computing the amount of underpayment subject to penalty. Through this mechanism, there would be an opportunity for thoughtful consideration and debate as to the disclosure requirement.

A "reasonable cause" provision should be added to the definition of the term "disclosed item" to excuse the failure to disclose an item under certain circumstances. Examples could include a change in the general understanding of the law taking place after a return was filed, or the unexpected litigation success of the IRS in establishing a position that many practitioners thought would not prevail.

Both the interest surcharge in H.R. 6300 and the understatement penalty in S. 2198 would technically be incurred even in the case of a mathematical or clerical error in the return (see Code section 6213(b)). This surely was not intended unless there is reason to believe the error was deliberate. This problem should be addressed.

Third Party Summonses

I am authorized to speak officially for the Section of Taxation in strongly supporting the amendments to the third-party recordkeeper summons procedures contained in section 131 of H.R. 6300. These amendments will shift the burden of instituting judicial procedures from the Internal Revenue Service to the taxpayer. Under H.R. 6300, a taxpayer who objects to a third-party recordkeeper summons must file a motion to quash within 20 days after a notice of the summons is served upon him. The Service may seek to enforce the summons in that proceeding. Similarly, the party summoned, that is the third-party recordkeeper, may intervene in that proceeding. A separate proceeding by the third-party recordkeeper is not contemplated.

These changes will reduce delays in obtaining information without prejudicing the rights which Congress granted taxpayers in Code section 7609 in the Tax Reform Act of 1976.

Several changes proposed in S. 1891 and other prior proposals dealing with this matter contained additional provisions to which the Section of Taxation strenuously objected. We are very pleased that these are not included in H.R. 6300. Specifically, under H.R. 6300, the taxpayer, the third-party recordkeeper and the Service will all retain their existing rights to appeal from an adverse ruling by the District Court. We believe that it is important to retain those rights and that appeals under existing law are not the cause of substantial or unwarranted delays. Under H.R. 6300, the third-party recordkeeper safeguards continue to apply to all taxpayers. S. 1891 and prior proposals would have improperly restricted those procedural safeguards to individuals and partnerships of five or fewer individuals.

The Section of Taxation also supports section 132 which will require third-party recordkeepers to assemble the summoned records upon receipt of the summons. This provision should also reduce delays. We suggest, however, that it may not always be possible for a third-party recordkeeper to locate and produce all of the records summoned within 20 to 23 days. The nature and volume of records requested should be considered in any requirement that a third-party recordkeeper produce records upon short notice.

It should be made clear that a third-party recordkeeper is entitled to reimbursement under Code section 7610 even if the summons is quashed. Failure to so provide may cause uncertainty and delay and thus frustrate the purpose of these provisions.

The Section of Taxation supports the provisions of section 132 which authorize the Internal Revenue Service to provide a certificate to the third-party recordkeeper that a motion to quash was not timely filed. Similarly, we support the provision that the third-party recordkeeper is not liable to any customer or other person if he produces records in good faith in reliance upon such a certificate or upon an order of a court requiring production of records. These provisions will significantly increase timely responses to third party summons.

These new provisions regarding third-party summons will reduce the caseload of the courts. They will eliminate substantial delays the Service has encountered in obtaining needed information while preserving taxpayer's and third-party's rights to obtain judicial review of those instances in which there is a substantial question regarding the propriety of an administrative summons.

Administrative Summonses

The Section of Taxation and the American Bar Association have not had an opportunity as yet to take a position on section 133, which seeks to clarify limitations upon the use of administrative summons. I personally support the intended purpose of section 133 to provide a clear point in time when an administrative summons may no longer be used because the investigation has shifted to a criminal prosecution purpose.

Subsequent to the opinion of the United States Supreme Court in United States v. LaSalle National Bank, 437 U.S. 298 (1978) there have been a significant number of cases in which taxpayers have resisted compliance with an administrative summons on the grounds that the Internal Revenue Service as an institution had shifted the nature of an investigation to a criminal prosecution purpose. In the LaSalle National Bank, case the Supreme Court held that an administrative summons was not authorized by Code section 7602 after the Service had recommended prosecution to the Department of Justice or after the Service had made an institutional commitment to refer the case for prosecution. H.R. 6300 provides a clear statutory line which would permit the Service to issue an administrative summons at any time up to the time it refers the case to the Department of Justice. Such a clear statutory rule would eliminate a significant number of controversies as to when the Service has made an institutional commitment to recommend criminal prosecution.

A clear statutory line is provided by authorizing issuance of a summons for the purpose of "inquiring into any offense connected with the administration or enforcement of the internal revenue laws" and then restricting that authorization by prohibiting a summons when there is a "Justice Department referral". This is generally a sound approach. The Service should not, however, be entitled improperly to delay referral. I believe that such action, were it to occur, would be subject to judicial review under the requirement that the Service act in good faith in issuing a summons set forth in United States v. Powell, 379 U.S. 48 (1964). I suggest that this idea be expressed in your Committee report.

I am also concerned that the authorization in section 133 of H.R. 6300 to use an administrative summons to inquire into any offense connected with the administration or enforcement of the internal revenue laws is too broad. It could be interpreted to provide authority for issuance of summons by agencies or bureaus other than the Internal Revenue Service, such as the Bureau of Alcohol, Tobacco and Firearms. Moreover, it may authorize use of a summons to inquire into alleged criminal conduct by an agent or employee of the Service. It does not appear to be intended to broaden the authority to use an administrative summons by agencies other than the Internal Revenue Service or for extraneous purposes such as I have described. Such matters, if they are to be included, require study and consideration of factors which may be materially different from those relating to use of a summons to inquire into an offense alleged to have been committed by a taxpayer, or a tax return preparer, in a tax matter.

There are also problems in the definition of when a Justice Department referral is in effect. It is not infrequent that cases involving one or more persons who have been investigated by the Service will be referred to the Department of Justice without a recommendation of criminal prosecution. This may occur when the Service has concluded that the Justice Department should decide which of the persons investigated should be prosecuted. In those circumstances, use of an administrative summons should be prohibited. The definition could be amended to provide that a Justice Department referral is in effect when the investigatory files concerning a person have been transferred to the Attorney General for consideration for criminal prosecution or with the recommendation that a criminal prosecution of the person be brought.

In supporting this proposed change, I am not unmindful that it is a significant departure from present authority granted the Service. Any such departure, however, may be largely, if not entirely, a matter of semantics. Under present law, the Service may investigate an alleged offense so long as there is also a purpose of determining a taxpayer's correct civil tax liability. Careful revenue agents can always conduct a combined criminal and civil inquiry to preserve such a dual purpose. Thus, the present authority granted the Service serves primarily to require maintenance of the form of a dual purpose when in fact the thrust of the investigation may well be to determine if a crime has been committed. Preserving the need to maintain that form of a dual purpose tax investigation serves no substantive purpose.

It may be argued that the grand jury is the protector of citizens against the state. Indeed, those are its origins. Review by a grand jury however, is required and would continue to be required in order to indict a person. Thus, the proposal does not eliminate the protections afforded by a grand jury review and indictment.

On the other hand, the proposals will eliminate procedural controversies regarding the propriety of an administrative summons. Eliminating those controversies will preserve the rights of taxpayers to contest a summons on substantive grounds. These rights are in fact greater than their rights to contest grand jury subpoenas. The new proposals will tend properly to insure adequate review of criminal investigation by lawyers in the Service and Department of Justice. The Section of Taxation is already on record in support of such legal reviews of the sufficiency of criminal recommendations by District Counsel and the Tax Division of the Department of Justice. Those reviews and the conference rights of taxpayers in criminal investigation cases are a significant, if not the most significant, assurance that criminal prosecutions will only be brought in circumstances in which there is a great likelihood that the government will prevail. Innocent taxpayers have the greatest chance of success in convincing the Government of their innocence because of the existence of those procedures. The proposals in H.R. 6300 will enhance and expand the availability of those procedures. For these reasons, I strongly support the proposed amendments with the modifications I have described.

II. Information Reporting

Interest Payments

Section 201 of H.R. 6300 would expand present law to require information reporting with respect to -- (1) obligations issued in registered form; and (2) obligations of the type offered to the public. It would also apply to original issue discount on these types of obligations. By reason of the registration requirements of section 102 of the bill, information reporting would thereby be required with respect to all obligations of the United States and obligations of corporations, partnerships, and trusts unless such obligations are not of the type offered to the public or have a maturity of less than one year.

It is also provided that pursuant to regulations, any financial institution, broker, or other person who collects interest for a payee (or acts as a payee's middleman), would be obligated to file any information return and information statement due on the transaction; no other person would have a reporting obligation with respect to any such payment.

Present law does not require information reporting as to obligations of the United States. In the past, the Bureau of Public Debt of the Treasury Department has opposed expansion of the information reporting rules to include obligations of the

United States. As a policy matter, the Treasury Department's failure to implement information reporting on the same basis as is required of private obligors is unacceptable.

The expansion of the reporting requirement to all obligations other than those issued by the natural person and those not of the type offered to the public is equally desirable. In my previous testimony on S. 2198 (which is identical in this respect to H.R. 5829), I stated that an exception to those reporting requirements should be made for small corporations because of the administrative burden it would place on those corporations and because it is unlikely that information reporting of interest on obligations of small corporations would have any significant effect on the compliance gap. Such an exception has, in effect, been provided since neither section 201 or 102 apply to obligations which are not of a type issued to the public. I continue to support such an exception. Section 201 also quite properly expands the reporting requirements to non-corporate entities.

While I endorse this provision, there is a technical deficiency relating to reporting on obligations which are issued prior to the effective date. The provision applies only to obligations issued after December 31, 1982. Thus, no reporting is required with respect to bearer obligations of the United States or with respect to any non-corporate obligations issued prior to that date. In its consideration of this provision, the Committee may wish to address these issues.

Returns of Brokers

Section 6045 of the Code presently requires brokers to make returns as required by regulations with respect to business transacted for customers. Such returns would include the customers' names and other information relating to the profits and losses arising from such transactions. No regulations have been prescribed under Code section 6045 even though the provision has been part of the tax laws for forty years. The Treasury Department is apparently reluctant to prescribe regulations at this late date because of concern that brokers will strongly oppose the imposition of any type of reporting requirements by regulation.

Section 202 of H.R. 6300 would amend Code section 6045 to define the term "broker" to include -- (1) a dealer; (2) a barter exchange; and (3) any other person who (for a profit) regularly acts as middleman in property transactions. The provision would also require each broker required to file an information return under Code section 6045 also to furnish each customer with a statement including the information provided in the information return.

Nonreporting of profits is particularly significant in securities and commodities transactions and barter exchange transactions. Information reporting by brokers should be required, and thus I strongly support this provision. I am concerned, however, as to the scope of the term "broker". The term is defined to include a dealer, but no definition of a "dealer" is provided. The term is also defined to include a middleman in a property transaction. The definition accordingly is much broader than brokers of securities and commodities. It may include real estate brokers and dealers, as well as other persons, with the exception of wholesalers. The scope of this provision should be clarified in order adequately to apprise all persons affected as to their reporting responsibilities. Moreover, the Committee should carefully consider each such other situation and make a determination whether it is desirable to require information reporting. Such a determination is much too important and controversial to be left to Treasury regulations.

Information Reporting -- Independent Contractors

Section 203 of H.R. 6300 expands the information reporting requirements with respect to payments in the course of a trade or business for services to persons who are not employees. It would also impose a new reporting requirement with respect to certain "direct sales".

While I strongly favor these improved and extended information reporting requirements with respect to payments to "independent contractors", they should not substitute for a more comprehensive examination by this Committee of the employee/independent contractor problem in the immediate future. That problem represents a major portion of the existing compliance gap, and it also involves potential unfairness to certain existing independent contractors which deserve a clearer exposition in the law as to their existing tax status. The Committee should determine the extent to which safe harbor rules clarifying the position of certain groups as independent contractors rather than employees are appropriate. The Committee should also consider the extent to which withholding on repetitive payments by a business payor to an individual rendering services should be imposed even though such person may be an independent contractor by common law standards. The determination whether withholding is appropriate should not be determined by common law rules developed long before the income tax system to resolve tort liabilities. It should be determined by the administrative feasibility and need for withholding in light of the degree of continuing relationship between the parties and extent to which repetitive payments are made by the payor to the payee.

With respect to the new information reporting provisions for "direct sale" transactions, I urge only that further consideration be given to whether these should be limited to sales to a buyer regularly engaged in selling such products on a direct sale basis or selling such products to other persons regularly so engaged. The Committee's report as to these provisions should make it clear that the reasonable cause exception to the penalty provisions should apply if the person required to file such a report did not know or have reason to know that the buyer was engaged in direct sales or in selling to persons engaged in direct sales. Persons may not know that their products are ultimately sold on a direct sale basis in some instances. For example, a candy manufacturer may sell its products to numerous sole proprietors for sale in their stores.

The manufacturer may not know that one of its buyers occasionally resells the product to a limited extent on a door-to-door basis.

State and Local Income Tax Refunds

Section 204 of H.R. 6300 would require information reporting as to state and local income tax refunds, credits, and offsets with respect to individuals. In addition, state and local governments would be required to file statements with respect to such returns with the recipients of such refunds, credits, and offsets.

It is my understanding that the compliance problem in this area is not as significant as in other areas. This apparently results from the fact that the current Form 1040 includes a line item for refunds. While information reporting would increase compliance, these benefits must be weighed against the resultant administrative burden placed on the state and local governments. H.R. 6300 attempts to address this problem, in part, through voluntary information exchange agreements between the Internal Revenue Service and the states. Nonetheless, the administrative burden of providing the recipients of such refunds with statements would appear to make the need for this provision questionable absent greater taxpayer noncompliance than that which currently exists.

Casualty Reimbursement

Present law allows a deduction of uncompensated personal losses in excess of $100 arising from a casualty or theft. There is no requirement under present law for payors of compensation for losses (insurance companies for the most part) to file information returns or to furnish information statements to the recipients of such reimbursements. Section 205 of H.R. 6300 would require the filing of information returns and the furnishing of information statements in any instance in which the reimbursement exceeded $600.

While Taxpayer Compliance Measurement Program (TCMP) data of the Internal Revenue Service indicate a high error rate in the reporting of casualty losses, it is not clear what portion of this total problem relates to the failure to take reimbursements into account. Moreover, it is not clear that reporting of the type provided in this bill would substantially assist taxpayers in properly reporting, at least in those instances where the taxpayer suffered multiple casualties during the year and received an information statement that did not specifically identify the casualty. The provision will impose very heavy and costly information reporting on insurance companies with questionable benefits as to increased tax compliance. These costs will be reflected in higher insurance premiums. The Committee should carefully consider the pros and cons of this provision.

Failure to File Information Returns or Supply Identifying Numbers

Section 211 of H.R. 6300 would increase from $10 to $50 the penalty for each failure to file information returns and would increase the maximum annual penalty for multiple failures to file information returns from $25,000 to $50,000. It would also impose a new penalty where the failure was intentional. In such circumstances, the penalty would not be less than 10 percent of the aggregate amount of payments not properly reported.

Section 212 of the bill would increase the penalty for failure to supply a taxpayer identification number. More specifically, the penalty would be increased from $5 to $10 where a taxpayer fails to include his identification number in his return. In addition, the penalty would be increased from $5 to $50 where a taxpayer fails to furnish his number to another person or a person fails to include in a return made with respect to another person such person's number.

Section 213 of the bill would provide for withholding at the source where a taxpayer fails to supply his identification number or supplies an incorrect number. The rate of withholding is established at ten percent. This provision would, in general, apply to information returns filed with respect to wages and other compensation, interest and dividends, and payments to non-employees and direct-sellers where the aggregate amount of payments during the calendar year equals or exceeds $600.

I strongly support all of these changes. The most significant aspect of these revisions is the provision for withholding. This is a very important and constructive change. It is a fair and effective means of increasing compliance, and the application of this concept to other areas deserves further consideration. It does not burden honest taxpayers and payors.

Form of Information Returns

Section 214 of H.R. 6300 requires that regulations be prescribed providing standards to determine which income tax or information returns must be filed in machine-readable form or on magnetic tape. In prescribing these regulations, the Treasury would be required to take into account the cost (among other factors) to the taxpayer. In contrast, present law permits but does not require taxpayers to provide information on magnetic tapes or other mediums, provided the prior consent of the Internal Revenue Service is obtained.

This provision represents a substantial improvement over section 104 of H.R. 5829. Nonetheless, problems still exist under this provision. For example, the provision on its face applies to income tax returns of individuals, as well as information returns. Clearly this is not intended. The Committee should also consider whether the Internal Revenue Service should be authorized to require a person to provide magnetic tapes where such tapes are not regularly used in the taxpayer's business activities. These are merely two examples of types of problems which could arise under this provision. At the very least, the Committee's report should include a discussion of the intended scope of the authority of the Service under the provision.

Paperwork Reduction

This provision would exempt rules and regulations under the Internal Revenue Code, and Internal Revenue Service tax forms, from approval by the Office of Management and Budget under the Paperwork Reduction Act of 1980. I am able to speak officially for the entire American Bar Association in strongly supporting this provision.

The tax administration process is not the type of regulatory activity to which the Paperwork Reduction Act was directed. Internal Revenue Service rulings, regulations, and tax forms provide essential guidance to taxpayers; the interests of taxpayers are served by greater rather than lesser activity in issuing and improving such rulings, regulations, and forms. The development of these materials requires extraordinary expertise, experience, and judgment by the Treasury Department, and the Office of Management and Budget does not have the necessary background to provide adequate review. OMB review would result in unnecessary delays and conflicts. Groups such as the Section of Taxation of the American Bar Association and the American Institute of Certified Public Accounts provide intensive and constructive criticism of all such materials. There is no widespread concern among tax experts that the Treasury Department has issued more rulings, regulations, or tax forms than the Internal Revenue Code requires.

III. Pensions and Other Retirement Income

Section 301 of H.R. 6300 seeks to improve compliance with respect to payments from deferred compensation plans maintained by employers and payments under commercial annuity contracts. The bill would achieve this objective by requiring additional information reporting by payors under such plans or contracts; by providing for withholding as to pension payments in the form of an annuity unless the pensioner elects not to have withholding apply; and by extending such a voluntary withholding system to forms of distributions from retirement plans which previously have not been covered --that is, installment payments and lump sum distributions.

Reporting

Existing law requires payors of pensions or annuities to report these payments pursuant to the general information return requirements of Internal Revenue Code §6041. In many instances, the party making the payment may not have enough information to provide the payee with the information needed by the payee to report correctly his or her tax liability. Usually, the necessary information is obtainable only from the administrator of the plan or the employer, and while plan administrators and employers usually provide this information to the payor, they are not required to do so.

Clearly, this information flow is essential to compliance in this area. The statutory authority provided in the bill is necessary.

Sections 301(c) of the bill includes a severe monetary penalty on any person who has a duty to file reports containing the information referred to above even though that person does not possess records necessary to provide such information. The penalty is in the form of an annual tax of $50 for each participant with respect to whom the failure occurred, with a maximum penalty of $50,000. Under certain circumstances, as where the failure to keep records is due to reasonable cause, the penalty is not applicable. The bill would leave to regulations the detailed recordkeeping requirements which would be required to avoid the penalty.

Since many different recordkeeping systems are used by plan administrators, it is doubtful that adequate regulations can be developed to provide the required certainty to avoid these substantial penalties. Accordingly, the recordkeeping penalty should be reconsidered. A better sanction may be to impose a penalty on the failure to provide correct information to the recipients of the payment. Thus, the focus would be on providing the necessary information to the payee, rather than on the mechanics of recordkeeping or assembly of that information.

The harshness of this penalty would be magnified if the early effective dates provided in H.R. 6300 (described below) are adopted. These dates should be changed.

Withholding

Under H.R. 6300, the taxable portion of annuity payments would, in general, be subject to withholding as if such payments were wages. The recipient could elect not to have withholding apply, and such an election would remain in effect until revoked. Payors would be required to notify recipients annually of their right to elect withholding (or to elect out of withholding previously elected).

This approach is preferable to the annual election requirement in S. 2198 and H.R. 5829. Although annual communications are required in each of these bills, payors should be able to give the annual notice required by H.R. 6300 without the considerable burdens that would be involved in administering year-by-year elections from payees.

Under H.R. 6300, withholding on installment pension payments would be at a flat 10%. This appears to be a simple and fair way to handle non-periodic payments and is analogous to the rules for wage withholding on extraordinary bonuses.

The withholding rate for "qualified total distributions" would be calculated on the basis of the ten year averaging and capital gain rules of section 402(e) of the Code. This would appear to require some very complicated withholding tables, given the nature of the computations required when ten-year averaging and capital gains (attributable to pre-1974 accounts) are involved. Perhaps flat rate withholding should be adopted here as well.

Effective Dates

The pension provisions of H.R. 6300 are generally effective for payments made in 1983 and thereafter. This date is much too early. This bill could not possibly become law for several weeks, if not months. The Internal Revenue Service must then issue regulations, and plan administrators must be given time thereafter to implement new procedures before the system can operate. Plan administrators could be encouraged by general exhortations in the legislative history to implement the new systems as soon as possible, but penalties should not be imposed with respect to any payments made within nine months after enactment.

IV. Transactions Outside the United States

H.R. 6300 attempts to deal with the difficulties of the Internal Revenue Service in obtaining information as to foreign transactions, both with respect to illegal income and foreign business activities. The two different classes of taxpayers involved present quite different compliance problems, however, and the problems involved should not be confused. The criminal who has violated various laws is not likely to be cooperative in furnishing information concerning his foreign transactions no matter what civil penalties are imposed. Further, our natural, strong inclination to root out narcotics dealers and other such criminals cannot serve to justify adoption of unduly severe burdens or penalties as to normal foreign business activities of law-abiding taxpayers.

No doubt some legitimate businesses also are at fault in refusing to provide books or records, or in their use of "delaying" tactics in dealing with the Internal Revenue Service. In many instances, however, the failure to produce all the documentation demanded by an examining IRS agent is due to the fact that the agent has demanded far more information as to foreign transactions than can reasonably be produced, at least within the time frame permitted. The Report entitled Tax Havens And Their Use By United States Taxpayers -- An Overview, January 12, 1981, by Richard A. Gordon specifically recognizes this when it states at page 197 --

> On the other hand, it was not our impression that most taxpayers procrastinatd. As industry groups have pointed out, it is both time

> consuming and expensive for a company to delay the conclusion of an examination. There is also the problem of imprecise requests for information from IRS agents. Industry groups have alleged that, in some instances, requests for information are "nothing more than fishing expeditions." Overly broad requests, such as requests for "all sales invoices of a particular foreign subsidiary" or "all communications between the foreign subsidiary and the parent company", have been cited. There is a great deal of reluctance to respond to such broad based inquiries, particularly when the materials are in a foreign country and in a foreign language.

Because of the very nature of the international transactions, it is probable that no fully-effective system for obtaining all the information desired by the Internal Revenue Service as to foreign transactions will every be devised. Improvements in the present system are possible, however, and such efforts should be encouraged. Unfortunately, there appear to be serious shortcomings in Title IV of H.R. 6300, and I urge that adequate time be provided within which to study these proposals in greater detail and to discuss them with the Congressional Staffs and the Treasury Department. Such additional careful study is particularly necessary here because the proposals in H.R. 6300 introduce new concepts for which there is no precedent or analogy in the tax laws.

Administrative Summons -- Persons Outside the United States

The bill would establish venue for summons enforcement action in the U.S. District Court for the District of Columbia as to persons not residing in (and not found in) any U.S. judicial district. Insofar as the proposal merely establishes venue for otherwise proper actions, it seems justified. In the time available for analysis, however, I have not been able to satisfy myself that the rights of a person residing abroad are adequately protected in this provision. Present law assures a taxpayer living in this country that he will be properly served and, therefore, will have knowledge of an administrative summons addressed to him. Further, notice to the taxpayer is required when an administrative summons is to a third party. How would these procedures be effected in dealing with persons living abroad, and particularly those in remote areas of the world? The bill does not address these important questions.

Failure to Provide Documentation Requested by Internal Revenue Service

Section 402 may be the most far-reaching new provision in H.R. 6300. It is addressed to any case in which a taxpayer fails substantially to comply with a formal document request by the IRS arising out of examination of the tax treatment of any item. In such a case, proposed new Code section 982(a) provides that a court in a proceeding in which the tax treatment of such item is in issue shall, on motion by the Government, prohibit the introduction by the taxpayer of any foreign based documentation covered by such request. An exception is provided if the taxpayer can satisfy the court that the failure to submit the information is due to reasonable cause. The bill provides that the fact that a foreign jurisdiction would impose a civil or criminal penalty on the taxpayer or any other person is not reasonable cause.

The scope of this proposal deserves careful reexamination. It is not limited to civil cases. If it is applicable in criminal tax fraud cases, it may very well be unconstitutional. The Constitution guarantees a taxpayer due process of law in the courts, and the introduction of evidence is vital to due process.

While the bill provides that the formal document request from the IRS must contain "a statement of the reason the documentation previously produced (if any) is not sufficient", it is likely that in practice the taxpayer will have no effective opportunity to enforce this condition. Further, and even more important, there is nothing in the bill which requires that the documentation demanded by the IRS be either reasonable or relevant. A response might be that, in such cases, the court trying the issue can be asked to determine whether reasonable cause existed. That, however, would be far too late a time in the proceedings to have the matter decided. The taxpayer could hardly take the risk when the original demand on him was made by the Internal Revenue Service that he could later demonstrate that such an IRS statement was unjustified. Under present law, if a taxpayer believes that a document request is unreasonable, he can force the IRS into a summons enforcement proceeding during which the validity of the document request can be tested. This new proposal would circumvent that procedure.

The U.S. case law is, in general, to the effect that the court will balance the competing factors in determining whether the U.S. should require an action which could result in violation of foreign law. See United States v. Vetco, Inc., 644 F.2d 1324 (9th Cir. 1981). Even this rule can work unfairly in some situations. In any event it would be unduly harsh and would be unfair to go farther and provide, as does the bill, that the foreign law is not even relevant.

The bill fails to draw any distinction between a wholly-owned foreign corporation and one in which the U.S. taxpayer has only a minority interest. In the United States a minority shareholder is not entitled to knowledge as to many elements of the corporation's activities, and disclosure by a corporation of information to a minority shareholder can precipitate various penalties depending upon the laws of the particular state. The provisions of H.R. 6300 must, at the very least, be limited to cases where U.S. persons control the foreign corporation.

The penalty may apply if the taxpayer refuses to deliver the original books and records of a foreign corporation, as distinguished from copies of the pertinent portions of the books and records. Foreign laws typically and justifiably forbid the removal from the jurisdiction of the originals of the books and records. Such prohibitions protect the creditors of the business entity, insure compliance with local tax laws, and serve other important purposes, and the U.S. tax system cannot fairly seek to override these protections.

It is doubtful, as previously suggested, that an extreme provision of this nature will be of any real value in dealing with cases involving the criminal element. A drug dealer who has violated U.S. criminal laws by dealing in narcotics, by failing to report his income from those activities, or by carrying large amounts of cash to overseas banks or other recipients, will not produce foreign records which may well convict him of criminal tax fraud. The burden of this extreme provision will fall upon U.S. business conducting legitimate foreign business activities, and in its present form, the provision is too Draconian in its effects.

Finally, serious questions arise as to the workability of the procedure. For example, when a taxpayer offers evidence in court, disputes are bound to arise whether that evidence was within or without the scope of the formal document request. Anticipation of this taxpayer contention may well cause the IRS to couch requests in very broad terms, creating greater uncertainties.

Some of the problems which may arise from the new formal document request procedure in H.R. 6300 would be alleviated by provision for judicial review. Procedures similar to the motion to quash procedures for third-party recordkeeper summons could operate to limit the harsh penalties applicable to a failure to produce to those situations in which a court had found the documents requested to be reasonable and relevant. Without, at the very minimum, review by a court prior to a trial on the merits, the uncertain application and *in terrorem* effect of the new provisions violate fundamental notions of fairness.

Foreign-Connected Amounts Presumed To Be Income

Proposed new Code section 982(b) would provide that any foreign-connected amount received by a U.S. person shall be presumed to be income, unless, on request of the Internal Revenue Service, sufficient documentation is provided to the Service to establish the true nature of the transaction. The Explanation states that it is directed at a case such as the following:

> For example, one common method employed by U.S. persons to launder drug profits is to carry the cash to a tax haven, deposit it with a small bank, and then have the bank lend the proceeds back to the dealer. The loan is fully documented. The IRS might try to assert a deficiency against the dealer. However, a properly documented phony loan transaction can make such a deficiency difficult to sustain.

The determinations of the Internal Revenue Service, however, are already presumed to be correct; the taxpayer must overcome this presumption initially. It is not clear what purpose this new presumption would serve. Further, it is doubtful for other reasons as well whether this new provision will be effective. A criminal who has already supplied false information probably will not hesitate to supply further false foreign documentation and thus will avoid the new presumption. If for some reason the drug dealer in the example decided to contest his tax liability in court, how would the IRS be in any better position to prove that the loan was not bona fide? The example states that the loan is fully documented, and therefore the drug dealer's lawyer presumably could introduce only the loan agreement and then rest his case.

Proposed section 982(c) provides a similar presumption with respect to foreign-connected deductions, credits, or other tax benefits which, under the presumption, would not be allowable. It presents the same problems.

Maintenance in U.S. of Foreign Books and Records

Proposed new Code section 982(f) provides that if subsection (a), (b) or (c) (see above) applied to the taxpayer with respect to any formal document request, the taxpayer may thereafter be required to maintain documentation with respect to the trade or business (or activity) at such place within the United States as designated.

This proposal is quite similar to proposed regulations issued by the Internal Revenue Service on January 23, 1981. The Section of Taxation submitted extensive comments with respect to those regulations. Those comments suggest that with respect to proposed section 982(f) --

1) It should be made clear that maintenance within the U.S. of true copies of foreign records is sufficient.

2) The taxpayer should have a right to select its principal place of business in the U.S. as the place where the documents are to be maintained.

3) The record-keeping within the U.S. should be for a stated period of time of reasonably short duration, and the taxpayer should have the right to contest the matter in court if the stated period of maintenance within the U.S. is unduly long.

4) The documentation required to be maintained within the U.S. should be limited in scope, and the taxpayer should have a right to contest the matter in court if the requirement imposed by the IRS is overly broad or too burdensome. Many foreign subsidiaries are often large businesses in and of themselves, and it may be physically impossible or prohibitively expensive to provide copies of an unnecessarily broad range of documents of the foreign corporation.

Recognition should be given to the degree of control of the U.S. taxpayer with respect to the foreign organization. As the bill is presently written, the IRS could require maintenance within the U.S. of documentation which a minority shareholder simply cannot obtain.

Information Returns

Section 411 of H.R. 6300 would impose a dollar penalty for failure to furnish information with respect to any foreign corporation required under Code §6038(a)(1). The penalty would be $1,000 per year, except that if the taxpayer is notified of his failure to file, then the penalty would become $1,000 for each thirty days after the expiration of ninety days from the notice.

The regulations under Code section 6038 call for the filing of Form 2952 with respect to each controlled foreign corporation. The Technical Explanation states that the proposed new penalty is to be imposed not only where there is a failure to file the required reports but also where the information is "inadequate". If one item of information is "inadequate" but the shortcomings, whatever they may be, do not presently affect the U.S. taxpayer's U.S. tax liability, it is difficult to see why there should be any penalty imposed. Moreover, the penalty should not be imposed if there exists reasonable cause for the inadequacy.

Information Reporting -- Foreign Personal Holding Companies

Section 412 of H.R. 6300 contains reporting requirements with respect to foreign personal holding companies. Under present law, only a fifty percent shareholder must file the necessary reports. Under the bill, a ten percent shareholder would be required to report.

No reasons are given for this proposed change. From the standpoint of equity, it may be entirely reasonable to require reporting from a ten percent shareholder who has acquired stock in a corporation which by its nature is a foreign personal holding company. There are situations, however, where the provision could work a hardship. A foreign corporation, owned mainly by U.S. persons, which is a manufacturing company, can rather easily and unwittingly become a foreign personal holding company. This can happen, for example, if the corporation has temporarily unneeded cash on hand which generates substantial interest income and, at the same time, the gross income from the manufacturing operations falls off drastically. Even under existing law a fifty percent shareholder may not be aware of the U.S. tax significance of this shift in the types of income, but one can at least rationalize that, being a fifty percent owner, he should know the consequences. Such a presumption does not necessarily attach to a ten percent shareholder, who may not be furnished with sufficient financial information to be put on notice of possible foreign personal holding company status. There should be a reasonable cause exception to this information reporting requirement.

Information Reporting -- Organizations and Reorganizations of Foreign Corporations

Section 413 would amend Code section 6046 relating to the time for filing returns as to the organization or reorganization of foreign corporations and as to acquisitions of their stock. Under present law, the time period for filing such returns is ninety days. Under the proposal, the time period would be ninety days "or on or before such later day as the Secretary may by regulations prescribe". This change is appropriate; it provides necessary flexibility in the reporting requirements. Similar flexibility in the time for filing returns as to certain foreign trusts under section 6048 is also proposed. This is equally appropriate.

V. Computation of Interest

Compound Interest

Under existing law, interest on overpayments and underpayments of tax is not compounded. H.R. 5829 and S. 2198 would require semi-annual compounding. Section 501 of H.R. 6300 would require interest to be compounded daily.

Under existing law, the rate of interest is adjusted annually based on an average of prime rates during one specified month of the prior year. Section 112 of H.R. 5829 and section 112 of S. 2198 would provide for semi-annual redetermination of the rate (effective January 1 and July 1 of each year) based on the average adjusted prime rate charged by commercial banks during the six months' period ended September 30 of the prior year and the six months' period ended March 31 of the current year, respectively.

The wide fluctuations in the prime rate and the resulting present 20 percent statutory interest rate under Code section 6621 demonstrate the need for using a more representative average adjusted prime rate rather than the prime rate for a limited prior period. In addition, the absence of compounding has substantially lowered the effective cost of borrowing funds from the Federal Government and thus has created incentives to delay the resolution of tax deficiencies. Accordingly, I strongly support some compounding and the changes in frequency and the method of determining the rate.

I urge the Committee, however, to adopt only semi-annual compounding as provided in H.R. 5829 and S. 2198 and to provide that no compounding shall occur with respect to the first three years. Daily compounding goes too far and does not increase the interest rate significantly over what is achieved with semi-annual compounding. In the case of underpayments of tax, it may create a very substantial perception of unfairness in the tax system, since daily compounding of interest does not occur with respect to loan transactions in general. It occurs largely with respect to savings deposits as a marketing technique to induce such deposits.

From a compliance standpoint, the essential problem with respect to compounding of interest is the delay it induces in settlement of tax disputes when, as at the present time, the statutory rate exceeds the market rate. Tax deficiencies normally must be settled within three years -- the statutory period for assessment of deficiencies. I recommend that compounding begin both for underpayments and overpayments only after three years.

Restrictions on Payments of Interest on Certain Refunds

Section 502 of H.R. 6300 would deny interest on a refund claimed in a late return if the refund is made within ninety days after the return is filed. A return would not be treated as "filed" unless filed in "processable form", which is defined as a return which -- (1) is filed on a permitted form; (2) contains the taxpayers name, address, identification number, and all required signatures; and (3) contains sufficient information to permit the mathematical verification of the tax liability shown on the return. Overpayments arising from net operating loss or capital loss carrybacks, or credit carrybacks, would be treated as arising only on the due date (including extensions) of the return for the year the carryback arose.

The changes relating to late and non-processable returns would be effective for returns filed after the thirtieth day following the date of enactment; the provisions relating to overpayments arising from carrybacks would become effective on enactment.

The denial of interest on a refund claimed in a late return if the refund is made within ninety days after the return is filed is sound, and this provision should be enacted.

The Committee's concern as to delays by taxpayers in filing claims for overpayment resulting from certain carrybacks is understandable, but the provisions of the bill are not a fair response and should not be adopted. Existing law already denies interest until the end of the year in which the carryback arises even though in principle, carrybacks are allowed because the annual tax accounting concept does not measure income properly. Losses and profits in different years must be averaged within limits to determine income fairly. It is at least arguable that interest should commence from the date the tax was paid for the year to which the loss or credit was carried back because no income was ultimately earned, and thus the tax was overpaid from the outset.

This, however, is merely to illustrate the point that the provisions of this bill are unfair. Existing law whereby interest begins only as of the end of the year the carryback arises has become widely accepted, and there is no need to change it. There surely is no justification, however, for arbitrarily denying the commencement of interest until the due date of the return (as extended) for such year. Furthermore, such a rule creates very undesirable pressures on taxpayers to rush the filing of returns to forego the necessity for extensions for filing. In the case of large corporate returns, it is virtually a universal practice that returns are filed with a six months' extension. Such extensions are granted automatically in recognition of the fact that they are essential to permit the filing of complete and accurate returns. This occurs because of the extreme difficulty of assembling all the necessary factual information (including that with respect to foreign branches and subsidiaries). Hundreds of different subsidiary corporations or branches, possibly engaged in many difficult types of business, may be involved in the case of a typical large, public corporation. It would be unreasonable to expect such a business taxpayer to be able to file its return in complete and adequate form much before the end of such period, given the extraordinary complexities of the U.S. income tax system.

It would be a serious error in administration from the standpoint of both taxpayers and the Internal Revenue Service to create pressures to rush the filing of these returns. This could result in much unnecessary waste in the tax administrative process, both for the taxpayer and the Internal Revenue Service. Section 502 of the bill also requires that the return must be filed in "processable" form. Extreme controversy would arise whether a corporate return filed as soon as possible after the end of the taxable year giving rise to the carryback, to avoid the loss of interest, would have met this standard. Corporate management would feel obligated to incur whatever overtime and other added costs were necessary to avoid loss of interest.

The interests of both business and the Government are better served by complete, carefully prepared returns, and it is for this reason that the 8-1/2 month period which includes extensions for filing the return has been given. Section 502 of the bill would upset this process without adequate reason.

Overpayments attributable to carrybacks of losses or credits sometimes arise only as a result of audit adjustments by the Internal Revenue Service long after the year in which the carryback arises. This cannot be anticipated by the taxpayer. The carrybacks often arise only as a result of shifting income or deductions as between years. It is unfair to deny interest on these carrybacks while interest runs on what, in effect, may be offsetting deficiencies.

I suggest that there are relatively few instances in which business taxpayers would deliberately delay the filing of refund claims to obtain an interest advantage. This can only arise in a period in which the statutory rate exceeds the market rate. This is much less likely to occur when the statutory rate is changed more frequently and is based on a more representative rate, as H.R. 6300 elsewhere provides. Even when such a disparity exists, most business taxpayers will file their refund claims at the earliest possible time; they are in business to manufacture or sell products or services, not to invest in Government obligations, and they need all the capital they can muster.

Accordingly, I urge the Committee not to change the treatment of interest on refunds attributable to carrybacks under existing law. Such a change is not justified, and it would create a severe perception of unfairness in the tax system. It has no counterpart in existing commercial practices.

If the Committee nonetheless decides to make some change, I urge that interest be denied only for any period by which the taxpayer's claim for refund or application for a tentative carryback adjustment is delayed beyond the time for filing the taxpayer's return as extended, and only if it arises other than by reason of an audit adjustment by the Service. This avoids any pressure to file returns before the due date while directly attacking the case where a taxpayer deliberately delays the filing of a refund claim to obtain an interest advantage.

VI. Tax Treatment of Partnership and Subchapter S Items

I strongly support the provisions for a unified examination, administrative and litigation procedure for resolving adjustments to partnership and Subchapter S corporation tax returns.

This new procedure would be beneficial both to the Internal Revenue Service and to taxpayers in the handling of Federal income tax adjustments arising from a taxpayer's membership in a partnership or Subchapter S corporation. It will relieve the examination and administrative review burdens of the Service; it will lighten court dockets; and it will avoid the inconvenience and uncertainty to the taxpayer of waiving the statute of limitations for all items in a return for a particular year simply because of the presence of a partnership or Subchapter S item on that return.

I will refer hereinafter only to partnerships and partners. In general, the same considerations apply equally to Subchapter S corporations and shareholders of such corporations, and my comments apply equally in such situations except as noted otherwise.

Under current procedures, the process of making adjustments to the returns of partners as the result of an adjustment at the partnership level requires the examination of the return of each of the partners, the issuance to each partner of a 30-day and perhaps a 90-day letter, the granting to each partner of an individual Appeals Office hearing, if requested, and the ability of each partner individually to litigate the question. Furthermore, the possibility exists in many cases, depending upon the residences of the partners, that the same issue will be decided by different courts for different partners. All of the foregoing duplications may occur even though the issues are identical for each partner. It is thus possible to have multiple and inconsistent resolutions of the same issue among the different partners.

Currently each partner must endure the inconvenience of an examination of his entire return for the year involved although only the partnership item is in question. He may be required to extend the period in which additional taxes may be assessed for his entire return although only partnership items are in question. (Although restricted consents are available in some circumstances, it is not a universal practice.) Because there can be multiple resolutions of an item, if more than one partner challenges the adjustment, each partner virtually is forced to challenge the adjustment to assure that he obtains the benefit of the best resolution.

The problem is difficult and time-consuming for the Service, and it is extremely inefficient and inconvenient for taxpayers, even in the case of relatively small partnerships the partners of which all are located within one Internal Revenue Service district. For larger partnerships with partners residing in many different districts, the problem becomes extremely difficult for the Service, with the need for many examinations, inter-district cooperation, and the sheer bulk of numbers despite the identity of issues. The frustrations and confusion of the partners keeps pace. Although many responsible national and multi-national partnerships, such as, accounting firms, law firms, and others, provide voluntary internal procedures to ease the burdens both on the Service and their partners, the problems of multiplicity still exist on both sides.

There exist many large partnerships in which this cooperation is not present. This is particularly true with respect to so-called "tax shelter" investments. The problem has been exacerbated in the last decade with the proliferation of tax shelters organized as partnerships, many of which are extremely large with participants scattered throughout this country and abroad. These groups, particularly those that are of marginal economic substance, not only do not cooperate with the Service, they actually profit from the inherent delay in the current system. The essence of many shelters is the mere passage of time, with the only monetary advantage being delay in the payment of tax and the use of tax money, sometimes interest-free in effect. The current system not only helps many of these shelters live; it actually, but most unfortunately, encourages their use because of the improved odds to the taxpayer of not being caught in the "audit lottery".

In the current climate of limited budgets, resulting in increased pressure on the system, and of bloated court dockets, particularly in the Tax Court, this ever increasing burden of multiplicity should be avoided, particularly where, as here, it is unnecessary. There is no need to resolve individually an identical issue in separate proceedings involving each separate partner. I am particularly concerned as to the ability of abusive tax shelters to proliferate and flourish simply because the current system is too ponderous to enable -- (1) speedy identification by the Internal Revenue Service of questionable arrangements facilitating widespread tax avoidance, and (2) IRS audits which will effectively prevent such avoidance.

Because of these concerns, the Internal Revenue Service has been working for over three years with cooperation from outside groups to develop a system that will ease these burdens on the Service, the courts, and taxpayers. The system included in H.R. 6300 interferes as little as possible with basic concepts of fairness in the tax determination process and the established procedures with which partners are presently familiar. It does change those procedures, and to some extent it necessarily limits the options that partners presently enjoy. Basic freedom has been preserved, however, and the limitation that is imposed is necessary to provide the continued efficient operation of the tax system. The limitations are only with respect to unduly broad freedoms or options in existing law, which are the core of the problem. Inasmuch as the essence of partnership taxation is a pass-through concept -- taxation at the partner level -- the primary concern in developing these provisions has been the preservation of the basic process which permits the partner to participate directly in the determination of his tax liability. This result is basically accomplished in the proposal before your Committee.

The new procedure would apply to all partnerships. My only disagreement in substance with the proposal is that I strongly believe there should be an exception for partnerships of ten or fewer partners, whether general or limited partnerships. It is less clear that such an exception is needed for Subchapter S corporations, and at this point I suggest only that in the case of Subchapter S corporations, this question be given further attention.

Such an exception for small partnerships is, however, particularly needed and appropriate for partnerships of ten partners or less. Such partnerships are exempt from the penalty under section 6698 for failing to file partnership tax returns, as explained in House Report 95-1445, 95th Cong., 2d Sess., 75 (1978) and in Senate Report 95-1263, 95th Cong. 2d Sess. 106 (1978).

I might have preferred to limit the universe somewhat further, but after consideration, I have concluded it could not be done effectively. A limitation by reference to any larger number of partners might have failed to embrace many tax shelter arrangements. Inasmuch as a prime objective of the new procedure is to reach tax shelters, if the threshold were to be set above ten partners, it would severely limit the use of the program. Any effort to limit the universe to "abusive" tax shelters would have run into the very severe difficulty of adequately defining an abusive tax shelter -- an effort which has been undertaken in other contexts so far without success.

Perhaps more important, the new process would not then have reached all large partnerships, which was a second goal of the procedure.

The alternative adopted in the proposal before this Committee is to encompass all partnerships. All of the most important objectives of the proposal will be accomplished, however, even with the limited exception I support, and much necessary interference with established tax reporting and compliance patterns will be avoided. These very small partnerships often do not file partnership returns, and are not required to do so. They treat themselves as co-ownerships rather than partnerships, and each co-owner resolves his own tax responsibilities separately as an individual with the IRS. There is no need to interfere with this established practice, which works well and does not present the serious administrative burdens at which this new proposal is directed.

The new proposal is carefully drawn to preserve the rights of partners to participate in both the administrative and judicial proceedings. Under the new procedure, every partner is entitled to participate in all administrative proceedings in connection with a proposed adjustment of partnership items. A partner may be represented in these proceedings by a partner designated by the partnership for this purpose, or a partner may participate individually or, as today, by a representative of his choice. Every partner, except a partner with less than a 1% interest in a partnership of over one hundred partners, may participate in any litigation, and even that partner may participate by joining a group which in the aggregate has a 5% interest. Thus, a very small partnership interest can protect against being unfairly represented by the majority.

With these protective provisions, the traditional partnership approach has been adequately preserved in a manner that is consistent with solving the major problem. There will be an infinitesimal number of circumstances where total distrust among the partners exists, but I submit that protection against this circumstance is not the function of the taxing system.

Mr. RANGEL. Thank you, Mr. Nolan.

Mr. Banks, you may proceed

STATEMENT OF DOUGLAS BANKS, MEMBER, SUBCHAPTER K TASK FORCE, FEDERAL TAX DIVISION, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Mr. BANKS. Thank you, Mr. Chairman.

My name is Douglas Banks, and I am appearing before you today as a representative of the Federal Tax Division of the American Institute of Certified Public Accountants. Nationally, the American Institute of CPA's represents approximately 175,000 certified public accountants, many of whom spend a substantial portion of their time dealing with income tax matters.

The American Institute of CPA's appreciates the opportunity to comment on bills H.R. 5829, introduced by Mr. Conable, and H.R. 6300, introduced by Mr. Rostenkowski. We commend both Mr. Conable and Mr. Rostenkowski for their efforts to improve compliance with the income tax laws through these two bills. The AICPA generally concurs with the desired objectives of most provisions of these bills.

We have previously submitted comments on Senate bill 2198, a bill identical to H.R. 5829, introduced by Senator Robert Dole in the Senate. We will be providing those comments along with more extensive discussions of H.R. 6300 for the record by the end of this week. I will devote my testimony to two provisions of these bills that we are most concerned with.

Section 125 of H.R. 5829 provides for a penalty for substantial underpayment of taxes arising for items not disclosed on the taxpayer's return.

We agree that a taxpayer should not be allowed to play the audit lottery by taking unsupportable positions that would be disallowed if discovered on audit but which are so artfully concealed that they are not apt to be discovered. However, we object to this particular approach because we believe it will prove to be counterproductive and have unanticipated results. The provision should be eliminated from the bill.

Requiring disclosure would only cause taxpayers with supportable positions to consider disclosure of assertive positions on their return, increase the cost of tax preparation, and exceed the IRS' ability to audit the detail being provided. Enactment of the provision as drafted would encourage taxpayers who have taken unsupportable positions in the past to continue to conceal those positions and rely on the audit lottery to avoid discovery. They would be even less likely to be audited as the IRS struggled to audit the tax returns with disclosure. In addition, existing provisions that impose market interest rates on assessed deficiencies should already discourage much of the perceived abuse. Section 503 of H.R. 6300, by adding a 20-percent surcharge to this interest rate, will even further discourage the abuse.

When the preparer penalty provisions were enacted in the Tax Reform Act of 1976, it was intended that such penalty apply generally to every negligent or intentional disregard of the Federal tax laws, rulings and regulations except that a good faith dispute by an income tax preparer about the interpretation of a statute expressed in regulations or rulings was not to be considered a negligent or an intentional disregard of rulings and regulations. By enacting section 125 of H.R. 5829, we believe that the Congress would sharply limit the taxpayers' rights to such a good faith dispute about the interpretation of a statute, regulation or ruling.

In addition, the provision upsets the longstanding relationship between the IRS, the practitioner, and the taxpayer. Due diligence in preparing a return would require a conscientious preparer to identify to the taxpayer any situation to which section 125 would apply. A conscientious practitioner would thus be placed in a position where he might be perceived by his or her client as an advocate of the IRS and an adversary of the taxpayer.

The implications of this provision are too important and far reaching to enact into law in haste. It is imperative that further study and consideration be given to the instances in which abuses exist and to effective approaches of discouraging those abuses.

Turning to H.R. 6300, specifically to title VI of the bill, the AICPA agrees with the concept that audits of partnerships by the Internal Revenue Service should be conducted on a centralized basis and that most of the administrative aspects contained in the bill are workable and desirable.

In particular, the ability of the "tax matters partner" to deal with the Service administratively will greatly reduce the inefficiencies of the present system regarding the actual audit, appeals conference and restricted consents to extend the statute of limitations.

We do not agree with two proposed major changes to the system of a partnership taxation.

The proposed unified judicial appeals process does not permit partners, other than the tax matters partner, their choice of judicial forums for partnership issues raised by the Internal Revenue Service. Many such issues which adversely impact one group of partners could result in windfall benefits to the tax matters partner. For example, assume the Internal Revenue Service proposed to reallocate losses from partners A, B, and C to partner D, and partner D is the tax matters partner for the partnership. Partner D would choose the court in which to litigate in which the precedents favor D's position and, while all other partners might join in the action, the choice of forum could clearly cause the decision to be against the interests of A, B, and C.

If the tax matters partner does not litigate, all other partners could be forced to the Tax Court if any one partner files a proceeding in that forum. Great inequities could result if a partner with a small deficiency is allowed to block the partners with greater shares from utilizing the Court of Claims or the district court.

We believe it is essential that the rights of partners to proceed in a single refund proceeding be preserved, whether or not one or more partners, including the tax matters partner, proceed in Tax Court. We agree that where the partners proceed in a district court action, only that district in which the partnership's principal place of business is conducted should have jurisdiction.

Another major change proposed by the bill would not permit partnerships to pay the tax proposed as a deficiency resulting from partnership adjustments and file a refund claim within 2 years after the payment as under existing law.

This proposal eliminates the rights of a taxpayer to benefit from subsequent favorable decisions even of the Supreme Court or from changes of position by the Internal Revenue Service during that 2-year period. If Congress intends to remove this aspect of refund litigation, then the legislation should be directed to all taxpayers, including individuals and regular corporations.

It seems likely, in view of the proposed change, that most audit adjustments would be disputed and carried forward to litigation if there was even a slight chance that other decisions would reverse the Internal Revenue Service's audit position. The advice of tax practitioners to their partnership clients would inevitably be to litigate, if only to keep open their rights to benefit from other cases and Internal Revenue Service position changes. So while this proposal would decrease tax cases by eliminating the so-called forum shopping on one hand, the bill would have the effect of encouraging litigation on the other hand.

A more desirable solution would be to permit the partnership through the actions of any partner to bring a single refund proceeding within 2 years after a tax is paid and to provide that all partners could be heard in that proceeding. This action would be available only to those partners who have not joined in any previous litigation with respect to the issues in dispute.

The proposals in the bill as they affect partners and partnerships are of great importance to the taxpaying public. While the AICPA recognizes the Treasury's concern over its crowded caseload in the tax shelter area, we believe the public should be given ample time to review this proposal and to comment on it. As mentioned earlier, the bill's provisions may even encourage tax cases.

If the bill were enacted with no changes from the present form, it would not affect tax litigation in the partnership area for a number of years. We believe it should be carefully studied before Congress enacts such sweeping legislation.

Thank you.

[The prepared statement follows:]

STATEMENT OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, FEDERAL TAX DIVISION

General Comments on H.R. 5829

The Taxpayer Compliance Improvement Act of 1982 (H.R. 5829) is intended to improve compliance with federal tax law through a series of provisions designed to encourage complete and accurate reporting of income and deductions. We generally concur with the objectives and agree with the concept of most provisions of the bill. The following comments on specific provisions of the bill concern those that we either object to or we believe require further study.

Specific Comments on H.R. 5829

Section 102—State and Local Income Tax Refunds.

The bill would require information returns for state and local tax refunds of $10 or more be filed with the IRS and taxpayers.

We support the concept of this provision. However, consideration should be given to increasing the level of refunds requiring reporting from $10 to $100. This increased limit would reduce the paperwork burden on state governments and the IRS and still accomplish the purpose of this section.

Section 113(a)—Interest with Respect to Delinquent Returns.

Under the bill, no interest will be paid on overpayments shown on late returns for any day before the date on which the return is filed.

We object to this provision. Enactment of this provision would codify a severe inequity against taxpayers. Except for the 45-day rule of Code Section 6611(e), we believe that the date from which interest runs should be the same date whether the late return entitles the taxpayer to a refund or results in an additional tax liability.

Section 113(c)—No Interest on Refunds Caused by Certain Carrybacks Until Claims Filed by Taxpayer.

Under the bill, interest will not be paid on overpayments resulting from a net operating loss or credit carryback before the date a claim is filed for such overpayment.

We object to this provision. Enactment of this provision would also codify a severe inequity against taxpayers. Again, except for the 45-day rule of Code Section 6611(e), we believe that the date from which interest runs should be the same date whether an adjustment to a prior taxable year entitles the taxpayer to a refund or results in an additional tax liability. If abuses are perceived to exist in this area, the changes proposed in section 112 of the bill should eliminate those problems.

Section 113(d)—Effective Dates.

We object to the effective date for the amendments made by Section 113(c). If Section 113(c) is enacted, it should be effective for tentative carryback adjustments filed after the 30th day after the date of enactment in lieu of payments of interest made after the date of enactment with respect to interest accruing after March 11, 1982. The provisions should apply only prospectively, so that taxpayers will receive a reasonable period of time to comply without an adverse effect.

Section 121—Fraud Penalty on Corporate Directors, Officers, Employees, and Agents.

The bill will impose a new civil fraud penalty on corporate directors, officers, employees, or agents who knowingly participate in fraud that results in an underpayment of tax by the corporation. Such individuals will be jointly and severally liable for a penalty equal to 50 percent of the part of the corporate underpayment due to fraud, but the amount that can be collected from any one individual will not exceed $100,000.

We agree with the concept of this provision; however, we object to the means of achieving the desired result. The use of such a large dollar amount as the maximum amount that can be collected from any one individual is clearly a case of legislative overkill and does not reflect the liable person's ability to pay. Further study is necessary in determining the appropriate penalty. We also believe that this provision should clearly differentiate corporate agents from tax return preparers, since penalty provisions already exist for tax return preparers. Section 6694 assesses income tax preparers with a civil penalty for certain negligent or willful attempts to understate a taxpayer's liability, while Section 7206 provides for criminal penalties. Section 121 also does not deal with the potential doubling up of penalties in the closely-held corporation when the officer is also a shareholder and, thus, impacted by corporate-level penalties.

Section 124(a)—Minimum Penalty for Failure to File Information Returns.

The bill increases the penalty for failure to file certain information returns from $5 to $50 per failure with a yearly maximum of $50,000. A minimum penalty will be imposed if the failures are due to intentional disregard of the filing requirements.

We agree with the concept of this provision but believe further study is necessary to determine the appropriate penalty.

Section 124(b)—Increase in Civil Penalty on Failure to Supply Identifying Numbers.

The bill increases the penalty from $5 to $50 per failure to a maximum of $50,000 per year, for a person who fails to: (1) include his TIN in a return, (2) furnish his TIN to another person, or (3) include, in any return or statement made with respect to another person, the TIN of such other person. If a failure of type (3) is intentionally made, the penalty is $100 per failure with no limit.

We agree with the concept of this provision but believe further study is also necessary to determine the appropriate penalty.

Section 124(c)—Withholding of Tax in Certain Cases.

The bill provides for withholding at the source at a tax rate of 15 percent if a taxpayer fails to supply a TIN or supplies an incorrect TIN to another person who must file a return with respect to payments to the taxpayer. Withholding would generally continue as long as the taxpayer failed to supply or correct his TIN.

We agree that withholding encourages compliance. However, we believe that further study should be made of the appropriate rate of withholding. Use of a 15 percent withholding rate may well encourage an unacceptable degree of noncompliance by taxpayers whose marginal tax rates exceed 15 percent.

We also feel that withholding at the source should be required only if a taxpayer fails to supply a TIN to another person who must file a return with respect to payments to the taxpayer. It seems unlikely, if not impossible, for a person to realize that the taxpayer has supplied an incorrect TIN.

Section 125—Penalty for Substantial Understatement.

The bill will add to the Code a new penalty for substantial underpayment of tax arising from items not disclosed on the taxpayer's return. The penalty will be 10 percent of that part of any underpayment of tax arising from an undisclosed item. An underpayment of tax will be substantial if it exceeds the greater of 10 percent of the tax required to be shown on the return or $5,000 for individuals, or $10,000 for corporations. The penalty may apply in addition to the negligence penalty but not the fraud penalty. An item will be considered disclosed only if information in the return, or an attachment to the return, is adequate to apprise the Secretary of the nature and amount of the item.

We agree that a taxpayer should not be allowed to play the audit lottery by taking unsupportable positions that would be disallowed if discovered on audit, but which are so artfully concealed that they are not apt to be discovered. We object to this particular approach because it will have the exact opposite effect on this perceived problem.

Enactment of the provisions as drafted would encourage taxpayers who have taken unsupportable positions in the past to continue to conceal those positions and rely on the audit lottery to avoid discovery. They would be even less likely to be audited as the IRS struggled to audit the tax returns with disclosure. Requiring disclosure will, we believe, only cause taxpayers with supportable positions to consider disclosures of assertive positions on their return, increase the cost of tax return preparation, and exceed the IRS's ability to audit the detail being provided. While the additional disclosure might increase the intellectual quality of tax controversies, it will not increase tax revenue. In addition, existing provisions that impose market interest rates on assessed deficiencies should already discourage much of the perceived abuse.

When the preparer penalty provisions were enacted in The Tax Reform Act of 1976, it was intended that such penalty apply generally to every negligent or intentional disregard of the federal tax laws, rulings and regulations, except that a good faith dispute by an income tax preparer about the interpretation of a statute (expressed in regulations or rulings) was not to be considered a negligent or intentional disregard of rulings and regulations. By enacting Section 125 of this bill, we believe that the Congress would sharply limit the taxpayer's right to such a good faith dispute about the interpretation of a statute, regulation, or ruling.

In addition, the provision upsets the long-standing relationship between the IRS, the practitioner and the taxpayer. Due diligence in preparing a return would require a conscientious preparer to identify to the taxpayer any situation to which section 125 would apply. A conscientious practitioner would thus be placed in a position where he might be perceived by his or her client as an advocate of the IRS and an adversary of the taxpayer. A premium will be placed on uninformed and less conscientious practitioners.

The implications of this provision are too important and far-reaching to enact into law in haste. It is imperative, that further study and consideration be given to the instances in which abuses exist and to effective approaches of discouraging those abuses.

General Comments on H.R. 6300

The Tax Compliance Act of 1982 (H.R. 6300), like H.R. 5829, is intended to reduce noncompliance with federal tax law. H.R. 6300, for the most part, encompasses the provisions of H.R. 5829, and includes additional provisions dealing with the likes of pension and annuity payments, foreign activities and audits of partnerships and Subchapter S corporations.

As with H.R. 5829, we generally concur with the desired objectives of H.R. 6300. The comments on H.R. 5829, to the extent they also apply to provisions of H.R. 6300, will not be repeated. We are continuing our analysis of the bill. Once we complete our study, we will provide members of the House Ways and Means Committee any additional comments or suggestions.

Specific Comments on H.R. 6300

We have had an opportunity to analyze and develop comments on the partnership proposals during the administration's drafting of those proposals.

In general, we endorse the administration's approach to unifying the audit and administrative appeals process. In particular, the ability of a "tax matters partner" (TMP) to deal with the Service administratively, will greatly reduce the inefficiencies of the present system regarding the actual audit, appeals, conference and restricted consents to extend the statute of limitations.

Judicial Review Procedure

We do not, however, support the Treasury's judicial review procedure. The AICPA acknowledges that a centralized judicial proceeding would be more efficient. However, the proposal strips tax-paying partners of "rights" that exist for all other taxpayers.

We agree that a district court petition should be filed in the district in which the partnership's principal place of business is located. We oppose, however, the provision dealing with the priority of a Tax Court action. This provision effectively does not permit partners, other than the TMP, their choice of judicial forums for partnership issues raised by the Internal Revenue Service. All taxpayers have traditionally been able to choose among three forums for the judicial appeal of a tax controversy: the Tax Court, the District Court and the Court of Claims. Legitimate tactical reasons are considered by taxpayers in selecting the judicial forum in which to appeal their case. Except for the TMP, the Treasury proposal would, practically speaking, eliminate this "right" to the partners of the partnership under audit. Since partners continue to bear the burden of any tax deficiency that may arise from audit settlement, and not the partnership, these partners should continue to have the same judicial flexibility as any other taxpayer under our current tax system.

In addition, this provision would preclude, in most cases, an appeal to any forum but the Tax Court. If the TMP does not litigate, all other partners would be forced to the Tax Court if any one partner files a proceeding in that forum. Great inequities could result if a partner with a small deficiency is allowed to block the partners with greater shares from utilizing the District Court or the Court of Claims.

We believe it is essential that the right of partners to proceed in a single refund proceeding be preserved, whether or not one or more partners (including the TMP) proceed in the Tax Court.

Statute of Limitations

Another major change proposed by the Bill, would not permit partners to pay the tax proposed as a deficiency on the partnership and file a refund claim within two years after the payment (as under existing law).

This proposal eliminates the right of a taxpayer (the partnership) to benefit from subsequent favorable decisions (even of the Supreme Court) or from changes of position by the Internal Revenue Service during that two year period. If Congress intends to remove this aspect of refund litigation, then the legislation should cover all taxpayers, including individuals and regular corporations.

It seems likely, in view of the proposed change, that most audit adjustments would be disputed and carried forward to litigation if there was even a slight chance that other decisions would reverse the Internal Revenue Service's audit position. The advice of tax practitioners to their partnership clients would inevitably be to litigate, if only to keep open their rights to benefit from other cases and Internal Revenue Service position changes. So while the unified judicial proceeding proposal would decrease tax cases by eliminating so-called "forum-shopping" on the one hand, the statute of limitation provisions could have the effect of encouraging litigation on the other hand.

In our view, a more desirable alternative to the administration's unified judicial proceeding proposal would be to permit the partnership (through the actions of any partner) to bring a single refund proceeding within two years of the payment of tax. All partners could join in this proceeding, except for those partners who had joined in any previous litigation with respect to the issues in dispute.

Mr. **Rangel**. Thank you.

Mr. Duncan?

Mr. **Duncan**. I do not have any questions, thank you.

Mr. **Rangel**. Mr. Moore?

Mr. **Moore**. No questions.

Mr. **Rangel**. On behalf of the chairman of the full committee, we thank you for your contribution.

The next panel will be Thomas Donohue, president, Citizen's Choice, and Prof. Charles Davenport, Rutgers University.

STATEMENT OF THOMAS J. DONOHUE, PRESIDENT, CITIZEN'S CHOICE, INC., ACCOMPANIED BY JOHN LYNCH, LEGISLATIVE COUNSEL

Mr. **Donohue**. Thank you, Mr. Chairman.

I have with me today Mr. John Lynch who is legislative counsel to Citizen's Choice.

I would make two opening comments: One, that Citizen's Choice is a national grassroots citizens lobby, particularly involved in taxpayers' activities, with approximately 75,000 individual members. I would also request and suggest that the full text of what we say be entered into the record, along with the written statement we have submitted today.

Mr. **Rangel**. Without objection, and that would apply to Professor Davenport as well.

Mr. **Donohue**. Thank you, Mr. Chairman.

Our comments today are quite brief. First of all, we agree, as has been suggested, with the many witnesses that have gone this morning, that something has to be done about the collection of taxes in the United States, and we encourage the work of the committee in moving forward with this bill. We will not make individual comments on the various sections of the legislation.

We would like to call to the committee's attention, however, to a study that was done by Citizen's Choice a few years ago. We were part of a commission called the National Commission on Taxes and the Internal Revenue Service. This study carefully, through a year of holding hearings and talking to taxpayers all around the country, looked at the problems between the collectors and the payers. That study, which has been discussed here numerous times by the members of the Commission and by the IRS itself, put forth recommendations to the Congress and to the Internal Revenue Service, many of which are being worked on.

I should point out three or four of the basic findings of that study. First of all, they found out that there are too many taxes. People avoid paying their taxes because they are such a large burden.

Second, the overriding feeling that came out of that study is that the collection system is based on fear.

And third, there was a general feeling that there would be more taxes collected if it were not for the complexity of the system. It takes a Ph.D. in economics, accounting and law to understand half of what is discussed in this room.

Our recommendations, therefore, are for the committee this morning to seize a great opportunity, that is, to proceed with your bill and to attach to it a small bill that would give you a chance to tell the taxpayer that while you are tightening down on the collection process, you are doing something to assure their protection before the Internal Revenue Service and the courts. We would propose, therefore, that you attach to your bill the Taxpayer's Procedural Safeguards Act, which we have attached to our statement. It is a very brief discussion which would codify certain necessary taxpayer's rights. It removes all of the, what I call the red herring material that everyone talks about, like the fellow who went up to Alaska and broke up a car. We are not talking about those lacks of judgment. We are talking about the procedural issues and the assurances of the rights of the individual taxpayer.

So we are suggesting, gentlemen, that while you go forward with your bill to tighten down on the individual taxpayer you amend your legislation to assure their rights under the law. The amendment we suggest we believe would greatly improve the taxpayer/IRS relationship and accordingly improve compliance.

I would make one final statement, Mr. Chairman. There has been a great deal of discussion today about a simplified tax system. Mr. Conable makes the point that it would never get through and it would just be politicized to death. I made the point to Senator Dole not long ago that clearly the lawyers, the accountants, the people that sit behind you and write tax legislation, lots of people are opposed to a simplified tax system. The only people that are for it are the people in your district. And we have got to do something. Not necessarily to go to a flat rate system, because I think Mr. Conable is correct there; but we do need to simplify the system.

In this regard, Citizen's Choice has formed a National Forum on Tax Alternatives, held its initial meetings with some of the distinguished leaders in this field, and submitted to this committee and to others a resolution signed by each of those people suggesting hearings on that subject.

Mr. Chairman, we commend you on your work and we ask you to look to the opportunity of assuring the rights of taxpayers while you strengthen the service's ability to collect their money.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF THOMAS J. DONOHUE, PRESIDENT, CITIZEN'S CHOICE, INC.

I am Thomas J. Donohue, President of Citizen's Choice, a national grass roots taxpayers' organization founded in 1976. Citizen's Choice has presently over 75,000 taxpaying members nationwide, representing all sectors of our society.

I am pleased to have this opportunity to testify before this committee on the "Tax Compliance Act of 1982." Citizen's Choice is well qualified to present testimony on this subject having made a year-and-a-half-long investigation into the relationship between the taxpayer and the Internal Revenue Service. One of the major conclusions of this study was that the current high rate of non-compliance is more the result of the worsening adversarial relationship between taxpayer and Internal Revenue Service, the incredible complexity of the present system, and the overriding perception of unfairness than the inability of the IRS to enforce the law. Moreover, the Citizen's Choice commission concluded that unless something is immediately done to improve the three problems outlined above and to radically simplify the present tax system, our historical concept of voluntary tax compliance will collapse.

We agree the Tax Compliance Act of 1982 would increase the ability of the Internal Revenue Service to enforce the tax laws. In part, the bill establishes increased reporting requirements and stiffer penalties for non-compliance as methods by which the "tax gap" could be reduced. We recognize the IRS has a very difficult and thankless job to perform. In this regard, one of the recommendations of the commission was that the Congress should be responsive to the Service's budget request. However, we do not believe that merely establishing additional reporting requirements, increased penalties or, for that matter, adding a host of additional auditing agents, will solve the compliance problem. We would suggest, that in addition to these measures, steps should be taken to immediately improve the relationship between the taxpayer and the IRS, and massively simplify the present tax system, and thus reduce the level of fear and anxiety associated with the present system.

We cannot emphasize strongly enough that the findings of the commission were frightening, and made it quickly apparent that the state of citizen/government relations is not well. Oppressive tax rates, the so-called voluntary compliance system in which fear is the primary catalyst for what volunteerism remains, and a system that is so unbelievably complex that few attorneys and accountants can understand it, has resulted in the wholesale avoidance of the tax laws through underground activities, shelters and cheating by otherwise honest individuals. This avoidance is expanding at an alarming rate and no method of enforcement exists that can deal with this situation.

The "Taxpayers Procedural Safeguards Act", which I have attached and make a part of my testimony today, and which is supported by Citizen's Choice and a coalition of taxpayers group, is a partial answer to the compliance problem and would be a worthy addition to the proposed Tax Compliance Act. We are aware that various bills of this nature have been introduced before, but feel convinced that perhaps Congress did not give it serious consideration because it was not aware of the severity of the situation or because the legislation was somewhat extreme and/or obsolete.

The legislation is highlighted by the following common sense changes and/or additions to the Internal Revenue code:

1. Prior to seizing the property of a taxpayer, the Internal Revenue Service would be required to first make attempts to enter into an installment agreement with the taxpayer, and failing to do so, to obtain a court order prior to seizure;

2. Would apply the foregoing requirements to the seizure of property used in an individual's trade or business and, in addition, would exempt from seizure the property used in a trade or business up to an amount not to exceed $5,000.00. This would ensure that the taxpayer was given every opportunity to maintain his business so that he would be capable of paying off his debt.

3. Would add to the miscellaneous section of the code:

(a) the requirement that an interview of any taxpayer be at a time and place convenient to both the taxpayer and the IRS;

(b) that simultaneously with the issuance of an audit notice, the taxpayer would be sent a list of Rights he has during and subsequent to an audit;

(c) that the taxpayer would be permitted to record interviews with IRS agents; and

(d) that the IRS must warn the taxpayer of his right to the presence of his attorney or accountant during an audit.

I would respectfully suggest, Mr. Chairman, that this necessary taxpayer rights legislation be added as an amendment to the "Tax Compliance Act of 1982." It is our opinion that the problem of tax compliance would be best solved if it is attacked in two ways. First, certain measures, as set forth in the "Tax Compliance Act", should be adopted. In particular, increased reporting requirements should be added. Secondly, the rights of the American taxpayer should be codified and these rights should be clearly and widely publicized. By doing so, the adversarial relationship between the taxpayer and the IRS would be minimized, and in turn, the rate of compliance would increase.

Despite the immediate need for the enactment of legislation directed at reducing the "tax gap" such legislation should be seen both by legislators and administrators as only part of a larger pattern of tax reform. Like the "Tax Compliance Act of 1982", the "Taxpayers Procedural Safeguards Act" provides only a short term cure to what is a much larger problem. I cannot emphasize strongly enough that the root of the problem lies with the complexity of the tax system itself. In order to solve the problem of tax administration once and for all, radical tax simplification is urgently required.

Recognizing this, Citizen's Choice recently convened "The National Forum on Tax Alternatives" which brought together twenty-eight distinguished invitees who discussed at length the topic of alternatives to the present tax system. This first step in what Citizen's Choice hopes will become a national debate resulted in a resolution, signed by the representatives, which called upon this committee to conduct hearings into the subject of tax alternatives. I have attached a copy of this resolution and make it a part of my testimony today.

It is the responsibility of Congress to guarantee that taxpayers are treated with respect and with the full measure of protection under the law that they are due as American citizens. It is also the Congress's responsibility to perceive a problem and to enact legislation which would solve it. Congress's task, therefore, like the problem we have discussed, is two-fold. First, Congress must enact legislation which would reduce the ever widening "tax gap". The Tax Compliance Act of 1982 and the Taxpayers Procedural Safeguards Act should be viewed as a two pronged attack to this problem. Secondly, and more importantly, Congress should recognize the root of the problem and take steps to drastically reform the present tax system.

On behalf of the members and staff of Citizen's Choice, I offer to this committee and to any of its members in particular, our assistance in any way you might find it helpful towards reaching our common goal of a more effective tax administration system. We look forward to working with you to this end.

Mr. RANGEL. Thank you, Mr. Donohue.

Mr. Guarini?

Mr. GUARINI [presiding]. Professor Davenport from Rutgers University.

STATEMENT OF PROF. CHARLES DAVENPORT, RUTGERS UNIVERSITY, NEWARK, N.J.

Mr. DAVENPORT. Mr. Chairman and members of the committee, my name is Charles Davenport. It is a pleasure to be with you to discuss the Tax Compliance Act of 1982. I teach tax law at Rutgers University in Newark, N.J. I am an alumnus of the tax legislative counsel's office, and I was Assistant Director of the Congressional Budget Office, Division of Tax Analysis. I appear here in my personal capacity.

Compliance with the tax law is a matter of concern. Almost daily we are assaulted with stories, anecdotes, articles, and books telling us about the low level of compliance. It is hard to know whether matters can be as bad as they are sometimes painted. They probably are.

Our system is said to be one of voluntary compliance, but for some time we have known that compliance is the highest where voluntarism is the least relied upon. Almost all wages are reported for tax purposes because the tax is withheld from them, and the taxpayer can get a refund only by filing a return on which the wages are shown.

The provisions of the bills before you are numerous. Although it is possible to overgeneralize, I have chosen to run this risk rather than stretch your patience by dealing extensively with each provision of the bill.

First, I turn my attention to those provisions that are devoted largely to expanding the reporting of information by those who pay sums of money to other taxpayers. While this expansion may be desirable, there is reason to doubt that the imposition of reporting will be effective in dealing with the compliance problems in these areas. Reporting requirements are imposed for dividends and interest, and the compliance problem for them is considered great. One might expect that reporting will not have the desired result in the areas to which it would be expanded under this bill.

This doubt is based in part on the belief that document matching by the Internal Revenue Service is beyond its starved administrative capacity, and I will return to that point later on.

Second, there are provisions that deal with persons attempting to obstruct the orderly interpretation and administration of the tax laws. It is difficult to have any sympathy for any of these groups. Most of us would, I think, cheer the enactment of these provisions.

Third, title VI dealing with the audit of partnerships and subchapter S corporations appear to be sensible administrative provisions.

Finally, I turn to part 1 of title I which might have been named "Tax Procedures for Supposed Criminals." It is difficult, I think, to be sufficiently critical of these provisions. Antipathy for them does not arise from sympathy for the proposed criminal, although I would emphasize that the expected application of the law is to supposed—not convicted criminals. Rather, the concern arises from the effect that such provisions have on the administration of the tax law. These provisions have less to do with the collection of taxes than they have to do with the removal of cash from the commerce in illegal substances.

So there are several reasons why assignment of that task to the Internal Revenue Service is harmful to the administration of the tax law. These provisions would allow the Commissioner to make jeopardy and termination assessments against persons who have or had cash believed by the Secretary—and you might read for "the Secretary" "a bureaucrat"—to have been used in or to be gross receipts from illegal activities. Illegal activity is activity of a kind which is subject to imprisonment under applicable law.

In making such an assessment, the Secretary is to presume that the cash is gross income. Persons who might be subject to this provision are likely to be identified by the Internal Revenue Service investigation or by local police authorities who then alert the proper Internal Revenue Service officials. Either means of identification very likely will misuse the Service's rather scarce resources. Cases involving illegal activities inherently involve a long investigation, frequently under the control of police authorities. Internal Revenue Service personnel may well be controlled by these police authorities who will have little hesitancy in spending the Service personnel and resources on cases that are good criminal cases but poor cases from a tax collector's viewpoint.

If the Service has not investigated the activities, the assessments are likely to be made at the behest of local police authorities who will view the jeopardy and termination assessments as just another way of depriving arrested persons of the ability to hire adequate legal counsel. Neither of these results is becoming to the Internal Revenue Service.

It is no answer to say that the American public wants to see the tax law enforced against the proceeds of criminal activity. I doubt that the American public thinks very hard or long on that subject. Indeed, the public polling that reflects such opinions are not well thought through. It might be more appropriate to ask John Q. Taxpayer if he wants to negotiate his civil tax liabilities with the police force. It seems unlikely that he does. And certainly, the image of the Internal Revenue Service as a police force—even as a bureaucracy out of control—would be strengthened by becoming more identified with the enforcement of criminal law. These provisions are hard to square with this administration's statements that the tax law should not be used for social purposes.

Even worse is the result produced inside the agency. If it is not limited to an even application of law to facts but rather is to engage in the enforcement of criminal law, the particular employee doing the enforcing would be hard put to pick fairly among those legally liable for such enforcement. In addition, the Internal Revenue Service will have to train its agents in the criminal law of more than 50 jurisdictions. The discipline of impartiality produced by limiting the agency to revenue matters is lost. That there is sufficient bureaucratic incentive to hunt criminals is hardly a justification for it.

The conferring of these extraordinary powers on the Internal Revenue Service will inevitably lead to their use with risks of their abuse. Their use will divert resources and in the long run do harm to the image of the Internal Revenue Service. The provisions of this bill will bring a return to the days of the now discredited termination and jeopardy assessment programs of the early 1970's.

This bill, then, has some positive aspects, some neutral ones, and some negatives. It could be improved by a few additional measures, and the present need for revenue would seem to provide the opportunity for more vigorous action that could serve us well.

It is ironic that the one area in which most estimators agree there is a great revenue loss from noncompliance has not even been addressed by this bill, the underreporting of dividends and interest. Now is the time to institute withholding on them. At most, withholding would be only marginally more burdensome on financial institutions than the information return programs are. Certainly adequate provision can be made to exempt low income taxpayers who will not have to pay any tax on their interest and dividends. The current concern about deficit reduction may present the best climate to take this step that will be present for some time to come. It would reduce the scope of voluntarism and raise the level of compliance.

There are two other steps that could be taken. One would be another stick to induce compliance, and one would be a carrot to those who are trying to comply. First, the level of funding for examination of returns should be significantly augmented. Examination of returns is now at an alltime low. It is possible that some of the funds necessary for this function could be rescued from data processing if the need to match documents was eliminated by imposing a requirement that tax be withheld on dividends and interest. Second, the funds for taxpayer services that have been so cut by this administration should be restored so that assistance in the preparation of returns can be expanded. These steps would help to maintain the balance in compliance strategies.

For the longer term there are two more steps that should be taken to improve compliance. First, the laws should be significantly simplified so that those most affected by it can have some understanding of it. Second, the preferences in the Code which have the purpose of compensating taxpayers for behavior or for the suffering of hardship should be eliminated. If these loopholes, preferences, tax expenditures or tax subsidies were greatly reduced or eliminated, the taxpaying public would likely consider the Code as being much fairer than it now is. The feeling that the law is fair is basic to a high level of compliance. Yet much of the legislation in the last 12 or so years has made the tax laws more unfair by granting special favors to classes of taxpayers.

When preferences spawn tax shelters that are abusive and perceived to be unfair by those who are unable to make use of them, the affected are likely to find their own shelters, some of which may not be legal, in an effort to return fairness to the tax law. As a consequence, the level of compliance drops.

It is no answer to say that these preferences are necessary for some nonrevenue purposes. That observation will not eliminate the unfairness of the tax expenditure. In a society that was built on the concept of self-help, we should not be surprised that those aggrieved by acts of the legislature take matters into their own hands.

I do not condone such conduct. It is simply certain to happen, and we should not believe otherwise. Until this source of noncompliance is dealt with, there is little likelihood that the remedies we discussed this morning will be of much value.

Can you imagine the thoughts that must be running through the minds of many Americans as they learn their Attorney General managed to obtain $4 of tax reducing deductions for each $1 that he paid? At a 50 percent tax rate, he will have reduced his tax bill by twice the amount of his cash payment. While ultimately his claim for these deductions may not withstand scrutiny, the average citizen must certainly question a system which provides even a colorable claim for such generous tax benefits. They cannot help but think that the affluent and well-to-do have been given a special privilege of paying less than their fair share of taxes. In those circumstances it seems unlikely that the provisions under discussion will have much impact on taxpayer behavior.

These remarks are not intended to demean the efforts that have gone into the bills before you. They are intended to put the bills into proper perspective. You can undoubtedly have a little impact on reporting behavior, but the reform of taxpayer conduct is not likely to come before there is a significant reform of the tax law.

Both of these last suggestions are long-range projects, but this committee should start on them. Even with them, there may not be much improvement in compliance. But without them, I cannot be very optimistic about the success of this bill or others having the same purpose.

I thank you for the opportunity to speak on these important and timely issues.

[The prepared statement follows:]

STATEMENT OF CHARLES DAVENPORT

Mr. Chairman and members of the Committee. My name is Charles Davenport. It is a pleasure to be with you this morning to discuss the Tax Compliance Act of 1982. I teach law at Rutgers University in Newark, New Jersey. I was the assistant director of the Congressional Budget Office (Tax Analysis) from 1975 to 1979. In 1974-1975, I directed a study, commissioned by the Administrative Conference of the United States, of the administrative procedures of the Internal Revenue Service. I have spent most of my life teaching, practicing, and writing about tax law.

Compliance with the tax law is a matter of concern. Almost daily we are assaulted with stories and anecdotes as well as articles and even books telling us of the low level of compliance in at least some sectors of the economy. It is hard to know whether matters can be as bad as they are sometimes painted. We are told that the budget would be in balance if there simply were compliance with the law. The level of compliance is said to be much worse than it was a quarter century, a decade, or even a year ago. One need not believe all that can be read to conclude that a higher level of compliance is desirable. It is appropriate that your committee has turned its attention to this problem in a time of budget stringency.

While our system is often said to be one of voluntary compliance, for some time most of us have known that compliance is the highest where voluntarism is the least relied upon. Almost all wages are reported for tax purposes because the tax withheld from them, and the taxpayer can get a refund only by filing a return on which the wages are shown. In these circumstances, the high level of compliance is understandable. How wonderful it would be if tax-withholding could be extended to all income. Withholding could, however, be significantly expanded, but this bill does not do so except in some relatively minor instances.

Because the provisions of the bill are numerous, it is not possible to deal with them individually without extending this discussion well beyond your patience. Although it is also possible to overgeneralize, I have chosen to run this risk rather than to stretch your patience by dealing extensively with each provision of the bill.

Titles II, III [1], and IV are largely devoted to expanding the reporting of information by those who pay sums of money to other taxpayers. A part of each of these titles is devoted to putting teeth into the reporting requirements. One of the teeth is a requirement to withhold if the taxpayer takes steps that may reasonably be construed as an effort to evade the reporting requirements.

Parts II, III, IV of Title I and Title V might possibly have been grouped together and entitled "Ways of dealing with persons attempting to obstruct the orderly interpretation and administration of the tax laws."

Title VI appears to be sensible administrative provisions that would merit passage even if there were no difficulties with unreported income.

Part I of Title I might have been named "Tax procedures for supposed criminals."

The expanded reporting provisions deal with areas where there undoubtedly has been a compliance problem: original issue discount obligations, capital gains, independent contractors, state and local income tax refunds, and casualty reimbursements. There is reason to doubt that the imposition of reporting will be effective in dealing with this problem. Reporting requirements are imposed for dividends and interest, and most knowledgeable observers believe that reporting has had little impact on the compliance problem. One might expect that reporting will not have the desired result in the areas to which it would be expanded under this bill.

Indeed, I believe that the bill implicitly concedes that reporting requirements have not been wholly effective. The bill will increase penalties for failure to file information returns and for failure to supply identifying numbers or for the supplying of inaccurate numbers. This latter misdeed would bring as a penalty for those who fail to give proper numbers what one might have supposed is the proper answer in the first place: withholding. Thus, the bill may improve the likelihood that information returns will be filed or that a penalty will be paid if they are not but unless our experience with dividends and interest is unique to them, I fear that the bill would do little to improve compliance. The public generally does not believe that the information returns are matched against individual income tax returns. Indeed, it seems likely that matching is an administrative task beyond the present capability of the Internal Revenue Service.

The next general area that I will deal with is those provisions designed to thwart obstructors of orderly assessment (return preparation) and administration of the tax law. Again generally, these provisions divide the world of tax obstructors into three categories: (1) those who profit from the sale of abusive tax shelters, (2) those who assist or counsel in the preparation of returns that contain inaccurate information, and (3) those taxpayers who seek to protest by filing frivolous returns.[2] It is difficult

---

[1] One might well conclude that the placing of Title III into the reporting category is simply incorrect. Instead, Part I might be viewed as imposing a withholding requirement that can be turned into a reporting requirement if the taxpayer makes a proper election to do so. Our experience with elections by the great mass of the taxpaying public that does not have access to expensive tax advice might also lead us to conclude that the election will not be exercised effectively in many circumstances, and the provision is thus much more likely to be a simple withholding provisions for the uninformed.

[2] Apparently, most of the taxpayers in this category attempt to avoid the procedures that are applicable when a return is not filed. Rather they file a return that is so inaccurate as to constitute no return at all. Because a paper is filed, however, the procedures applicable to returns are

Continued

to have any sympathy for any of these groups. Most of us would, I think, cheer the enactment of these provisions. Probably, they should have been on the books long ago. Although one would not expect them to achieve complete reform in these areas, they will provide useful tools in the tax collector's arsenal. On balance, they are a neutral if not a plus.

It is difficult, I think, to be sufficiently critical of the provisions aimed at supposedly criminal activity. I refer to the provisions that would allow the Internal Revenue Service to use jeopardy and termination assessments where cash is in the possession of a taxpayer. Antipathy for those provisions does not arise from sympathy for the supposed criminal—although I would emphasize that the expected application of the law is to supposed, not convicted, criminals. Rather the concern arises from the effect that such provisions have on the administration of the tax law.

To deal with them adequately, we must first speculate just a bit on the psychology of tax compliance. We know that the payment of taxes is not a pleasant experience for most of our citizens, and we have largely spared them the need to inflict discomfort on themselves. Rather we collect most of our income tax by having the employer withhold taxes from wages and salaries before they are paid to the taxpayer. This system of involuntary withholding has been combined with voluntary self-assessment on other kinds of income. Knowing, however, that mistakes are made, that judgment calls are required, and that some returns would be in need of correction, the Internal Revenue Service long ago initiated a system of auditing some returns. The Internal Revenue Service thus came to have something of a policeman's image. Undoubtedly, that image is desirable at least to some extent. On the other hand, the Internal Revenue Service initiated services to give assistance to taxpayers in coping with the complexity of the law and the agency that administered it. While managers were not always able to prevail upon those on the firing line, they said that they wanted to cultivate the image that the Internal Revenue Service is helpful to those attempting to comply with the law. This might be called the social worker's image. The combined effect of these two images has been, I think, to create the impression of a likelihood that a mistake or deliberate attempt to improperly cut taxes would be discovered and corrected by the Internal Revenue Service while it also appears to be helpful to those who try to comply.

Against that background, we can turn to the provisions of the bill dealing with the collection of tax from income generated by crime. (In fact, the major, if not the only, illegal activity contemplated is the illegal sale of marijuana and narcotic drugs.) These provisions have less to do with the collection of taxes than they have to do with the removal of the cash from the commerce in illegal substances. There are several reasons why that is harmful to the proper administration of the tax law.

These provisions would allow the Commissioner to make jeopardy and termination assessments against persons who have or had cash believed by "the Secretary" to have been used in or to be gross receipts from illegal activities. Illegal activity is activity of a kind which, under applicable Federal, State, or local law, is punishable by imprisonment. In making such an assessment, the Secretary is to presume that the cash is gross income.

Persons who might be subject to these provisions are unlikely to wear sandwich boards announcing that they are in the possession of cash that might have been used in or derived from illegal activities. They are much more likely to be identified by Internal Revenue Service investigation or by local police authorities who then alert the proper Internal Revenue Service officials. Either such means of identification very likely will misuse the IRS's rather scarce resources. Cases involving illegal activities inherently require a long investigation—frequently under the control of police authorities. Internal Revenue Service personnel may well be controlled by forces outside the Internal Revenue Service. These forces may well squander the Internal Revenue Service personnel and resources on cases that are likely to produce little revenue for the amount of time invested. If the Internal Revenue Service has not investigated the activities, the assessments are likely to be made at the behest of local police authorities who will view the jeopardy and termination assessments as just another way of depriving arrested persons of the ability to hire adequate legal counsels. The Internal Revenue Service thus will be able to do what the local police are prevented from doing—in effect, deprive the taxpayer of property without due process of the law at a time when command of resources is very important to a legal defense. Neither of these results is becoming to the Internal Revenue Service.

---

followed, and the taxpayer is able to put off the day of reckoning for a substantail period. Indeed, some of these taxpaers have stalled the tax collector so long that they frequently gain considerable media attention by claiming that they have not paid taxes in several years and have done so with impunity.

It is no answer to say that the American public wants to see the tax law enforced against the proceeds of criminal activities. I doubt that the American public thinks very hard or long on that subject. Does it expect the tax collector to take a cut of the price paid for a hired assassin? Most likely not. Does it expect the Internal Revenue Service to share in the proceeds of a bank robbery? Probably not. No one would assert that the provisions in question were intended to operate in these circumstances. Rather they were intended to operate against illicit drug dealers and perhaps numbers runners. The more heinous the crime the less likely that these provisions can be used in any meaningful way. Yet as we omit these most serious and clearly immoral crimes, we move into activities which many persons simply do not think should be illegal because they do not regard them as inherently evil. For example, many people believe that the smoking of marijuana is not inherently wrong and would argue that but for the involvement of organized crime, use of marijuana does no harm to society. They would add that organized crime is involved only because this society has chosen to make illegal the obtaining and use of marijuana. When the Internal Revenue Service mixes itself into enforcing criminal laws so lightly regarded by a signficiant portion of our society, it takes on the image of an abusive policeman and enforcer of a morality not universally shared. This image is not one that serves it well when it must then deal with the citizenry over tax matters. Rather than being an impartial applier of law to facts, it appears to be a vindictive, moralizing law enforcement agency.

Even worse is the result produced inside the agency. If it is not limited to an even application of the law to facts, but rather is to engage in the enforcement of criminal law against conduct regarded by some as morally benign, the particular employee doing the enforcing will be hard put to pick fairly among those legally liable for such enforcement. The discipline of impartiality produced by limiting the agency to revenue matters is lost. That there is sufficient bureaucratic incentive to hunt criminals is hardly a justification for it.

Although much of the public is ready to opine that the fight against crime gives the Internal Revenue Service a positive image, it is doubtul that the public polling that reflects such opinions are well thought through. It might be more appropriate to ask John Q. Taxpayer if he wants to negotiate his civil tax liabilities with the police force. It seems unlikely that he does. Certainly, the image of the Internal Revenue Service as a police force—even as a bureaucracy out of control—would be strengthened by its becoming more identified with the enforcement of local crimes.

The conferring of these extraordinary powers on the Internal Revenue Service will inevitably lead to their use—with risks of their abuse. Their use will divert resources and in the long run do harm to the image of the Internal Revenue Service. The provisions of this bill will bring a return of the days of the now discredited termination and jeopardy assessment program of the early 1970s.

The viewing of the tax law as an essay in private morality is likely to arise in other contexts very shortly. There are now pending several bills that deny all deductions of illegally produced income. Such bills are simply unadministrable as well as conceptually wrong. The Internal Revenue Service would be required to train its agents in the criminal law of each jurisdiction. The tax law would lack uniformity from state to state. Taxpayers otherwise willing to file correct returns would be inclined not to file or to omit gross income or to mislabel income and expense decutions to prevent a tax law penalty which may constitute the only penalty ever exacted for a local crime. The upshot is that there would be less compliance than there now is. Despite the enraged outcries of a few over the Tax Court's recent allowing of business deductions to a drug dealer, both the public and the Internal Revenue Service will be better off if this Committee will simply turn a deaf ear to those who would change the principle that the income tax is to be laid on net income, not gross income.

This bill then has some positive aspects, some neutral ones, and some negatives. It could be improved by a few additional measures, and the present need for revenue would seem to provide the opportunity for more vigorous action that would serve us well. It is ironic that the one area in which most estimators agree there is the greatest revenue loss from compliance has not even been addressed by the bill: the underreporting of dividends and interest. Now is the time to institute withholding on them. At most it would be only marginally more burdensome on financial institutions than the information return programs are. Certainly, adequate provision can be made to exempt low income taxpayers who will not have to pay any tax on their interest and dividends. The current concern about deficit reduction may present the best climate to take this step that will be present for some time to come. It would reduce the scope of voluntarism and raise the level of compliance.

There are two other steps that could be taken. One would be another stick to induce compliance and one would be a carrot to those who are trying to comply. First, the level of funding for examination of returns should be significantly augmented. It is possible that some of the funds necessary for this function could be rescued from data processing if the need to match information documents was eliminated by imposing a requirement that tax be withheld on dividends and interest. Second, the funds for taxpayers services that have been so cut by this administration should be restored so that assistance in the preparation of returns can be expanded. These steps would help to maintain the balance in compliance strategies.

In addition, for the longer term there are two more steps that should be taken to improve compliance. First, the law should be sufficiently simplified that most of those affected by it can have some understanding of it. Simplification is a difficult process, but it is one that has never been seriously considered or tried. Second, the preferences in the Code which have the purpose of compensating taxpayers for behavior or the suffering of hardship should be eliminated. If these loopholes, preferences, or tax expenditures and subsidies were greatly reduced or eliminated, the taxpaying public would likely consider the Code as being much fairer than it now is. The feeling that the law is fair is basic to a high level of compliance. Yet, much of the legislation in the last 12 or so years has made the tax law more unfair by granting special favors to classes of taxpayers. When preferences spawn tax shelters that are abusive and perceived unfair by those who are unable to make use of them, the afflicted are likely to find their own shelters—some of which may not be legal—to return "fairness" to the tax law. As a consequence the level of compliance drops. It is no answer to say that these preferences are necessary for some non-revenue purpose. That observation will not eliminate the unfairness of the tax expenditure. In a society that was built on the concept of self-help, we should not be surprised that those aggrieved by acts of the legislature take matters into their own hands. I do not condone such conduct. It simply is certain to happen, and we should not believe otherwise. Until this source of non-compliance is dealt with, there is little likelihood that the bandaid remedies that we discuss will be of much value.

Can you imagine the thoughts that must be running through the minds of many Americans when they learn that their Attorney General managed to obtain $4 of tax reducing deductions for each $1 that he paid? At a fifty percent tax rate, he will have reduced his tax bill by twice the amount of his cash payment. While ultimately his claim for these deductions may not withstand scrutiny, the average citizen must certainly question a system which provides even a colorable claim for such generous tax benefits. Also most of them will know that there is little prospect that all such shelters can be audited by the Internal Revenue Service. They can not help but think that the affluent and well-to-do have been given the special privilege of paying less than their fair share of the taxes. In those circumstances, it seems unlikely that the provisions under discussion this morning will have much impact on taxpayer behavior.

These remarks are not intended to demean the efforts that have gone into the bill before you. They are intended to put the bill into proper perspective. We can undoubtedly have a little impact on reporting behavior, but the reform of taxpayer conduct is not likely to come before there is a significant reform of the tax law.

Both of these last suggestions are long range projects, but this Committee should start on them. Even with them, there may not much improvement in compliance. But without them, I can not be very optimistic about the success of this bill or others having the same purpose.

I thank you for the opportunity to speak on these important and timely issues.

Mr. **GUARINI**. Thank you very much, Professor Davenport.

Mr. Duncan.

Mr. **DUNCAN**. No questions, Mr. Chairman.

Mr. **GUARINI**. Mr. Moore.

Mr. **MOORE**. No questions.

Mr. **GUARINI**. Professor Davenport, what tax expenditures would you eliminate?

Mr. **DAVENPORT**. I'm sorry, did you ask which ones should we start with?

Mr. **GUARINI**. Well, do you have a suggestion of tax expenditures that should be top on the priority list that we should actually eliminate? The oil depletion tax or DISC or what?

Mr. **Davenport**. I think the first thing you should do is go back and reconsider the accelerated cost recovery system, which you enacted in 1981. You cannot handle it by repealing the leasing provisions. That simply will limit the benefits to a few, and effectively, as I understand those provisions, they simply have eliminated the income tax on most investment income now.

Mr. **Guarini**. We just had that national debate and we just passed that law, so we're not going to go backward at that point. I wonder if you have any other suggestions on tax expenditures that we have had long standing in the law that should be done away with?

Mr. **Davenport**. Obviously, one can make up quite a list. You can certainly do away with some of the industrial development revenue bonds. You can put some limits on the amount of contributions that can be made for medical care. I think probably that would be good as a medical practice itself.

Mr. **Guarini**. Without pressing you at this point, if you have any suggestions that you want to put into the record or would want to write a letter on, we will keep the record open so that you can do that.

Mr. **Davenport**. I will be glad to send you a list of them. One could of course respond by saying if you simply take a look at the tax expenditure budget and repeal all of those, you have accomplished your purpose. I don't think any of us are so unrealistic as to believe that those things are likely to come about, although I think that probably would be a good result and then we would have a simple law and could have much lower rates.

Mr. **Guarini**. Thank you very much, Professor, and Mr. Donohue. We appreciate the benefit of your thinking. If you want to add anything later to the record, we would appreciate whatever you send in. Thank you.

Mr. **Davenport**. Thank you.

Mr. **Donohue**. Thank you.

Mr. **Guarini**. Mr. Chuck Rau of the National Association of Manufacturers; Mr. Monty Barber, Direct Selling Association; Mr. Andre Maisonpierre, the Alliance of American Insurers; Mr. Karl H. Velde, Jr., representing the Public Securities Association; Mr. Norman M. Epstein representing the Securities Industry Association. We welcome you gentlemen here and would appreciate hearing from Mr. Chuck Rau, who is the chairman of the corporate income tax and capital formation subcommittee of the National Association of Manufacturers.

STATEMENT OF CHARLES W. RAU, CHAIRMAN, CORPORATE INCOME TAX AND CAPITAL FORMATION SUBCOMMITTEE, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. **Rau**. With the chairman's permission, in order to save time I would like to highlight from our prepared text, which I ask be accepted in total for the record.

Mr. **Guarini**. It will.

Mr. **Rau**. I am appearing today for the National Association of Manufacturers, which represents nearly 12,000 member firms, who account for nearly 80 percent of the Nation's industrial output and 85 percent of the Nation's industrial work force.

NAM supports the basic thrust of H.R. 6300, which is to increase taxpayer compliance through the use of improved information reporting requirements and stricter penalties on those who violate the Federal tax laws.

NAM is concerned, however, that this committee not place unnecessary or onerous burdens upon the legitimate business sector of our society. We therefore request that this committee, in its consideration of taxpayer compliance legislation, reaffirm the merits of our self-assessment system by not penalizing the overwhelming majority of honest businessmen who seek to comply with an ever-increasing burden of governmental reporting.

With these thoughts in mind, the NAM believes that this legislation would be more effective if the following provisions were modified or deleted. Section 102 of the bill would not permit a deduction for interest paid on corporate obligations required to be registered and which were not registered. This provision, if enacted, could have serious consequences for Eurodollar debt offerings by U.S. firms. Eurodollar debt offerings are invariably in bearer form, and there are few, if any, overseas markets for obligations issued in registered form. Enactment of this provision could close off this important source of capital for U.S. companies.

The NAM therefore recommends that this provision be modified to be made inapplicable to those obligations offered outside of the United States.

Section 402 purportedly attempts to deal with laundered cash or a misrepresentation of facts. This section should be carefully scrutinized before it is included in final legislation. One of the most acute problems fostered by this section is that of a domestic corporation which would be required to present documentation in the United States which under foreign law is not permitted to be removed outside the foreign country. This could present a draconian choice to the business taxpayer, who must choose between obeying domestic U.S. law or obeying the law of a foreign government.

Another potential problem with this section is that it creates substantial presumptions against taxpayers, including legitimate business taxpayers, that could be difficult to overcome through no fault of such taxpayers. While existing law and procedures permit the use of alternative documentation, it appears this section places the legitimate businessman in unnecessary jeopardy by introducing new burdens of proof which the businessman must bear.

The NAM recommends continuation of existing law in this area, absent a showing of probable tax fraud.

Section 502 of the bill denies the payment of interest on an overpayment resulting from a net operating loss or tax credit carryback. It also provides that no interest is to be paid on a refund claimed on a return filed after the last day prescribed for filing the return, including extensions.

We believe the second provision properly attempts to deal with persons who specifically seek to maximize their interest income by deferring the filing of a tax return beyond the due date. Alternatively, we strongly oppose the proposal to deny interest because of overpayments resulting from a net operating loss or tax credit carryback.

We believe a basic sense of fair play is required by the Government in dealing with its taxpayers. Taxpayers are required to pay tax on an audit deficiency based on subsequently issued regulations or a court case that may have decided years after a return is filed. To deny taxpayers interest from the first day of the year following the year in which they incur a loss which gives rise to this carryback does not appear evenhanded and, in the context of our current economic situation, could even be viewed as equivalent to a tax increase in loss corporations. We strongly suggest that this provision be deleted.

Section 503 provides for a nofault nondeductible surcharge due to a substantial understatement of tax. While this provision is preferable to the penalty and burdensome disclosure provisions of H.R. 5829, the NAM believes that this section is unwarranted and that its penalty provisions are unduly harsh.

The NAM is strongly opposed to this section. We believe that the self-assessment system has worked to a significant degree and that the system is undermined by a nofault provision that penalizes taxpayers who make a good faith effort to comply with our tax law. Our tax laws are exceedingly complex and give rise to a substantial amount of uncertainty.

At this time of substantially reduced business income, the threshold amounts may provide little solace to business taxpayers. The fact that the Secretary may choose to waive this penalty is in our view not an adequate substitute for the rule of law or good tax policy. We therefore recommend the deletion of this section.

In conclusion, the NAM believes that the citizens of our country, be they individual or corporate, have a responsibility to comply with the tax laws of our country. We appreciate the need in certain cases to strengthen the reporting requirements of existing law and believe the majority of our members would be willing to absorb a reasonable increase in governmental reporting to assure the evenhanded application of our tax laws.

We ask this committee, however, not to place unwarranted or onerous burdens upon the business community in seeking to achieve these goals. We particularly ask this committee to reject the levying of nofault penalties against taxpayers; not to deny interest to taxpayers where the Government in fact has had the use of their money; not to place U.S. companies doing business abroad or seeking to borrow abroad in untenable or noncompetitive positions; and finally, that any new penalties levied for failure to report information be on those who refuse to provide accurate information as to their identification, rather than on those with whom they do business.

Thank you, Mr. Chairman, for the opportunity to present our views at this hearing. We certainly hold ourselves open to work with the committee in the weeks ahead.

[The prepared statement follows:]

STATEMENT OF CHARLES W. RAU ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

My name is Charles W. Rau and I am Director of Taxes of the Allis-Chalmers Corporation. I'm appearing today on behalf of the National Association of Manufacturers [NAM], as Chairman of its Corporate Income Tax and Capital Formation Subcommittee. NAM represents nearly 12,000 member firms who account for nearly 80 percent of the nation's industrial output and 85 percent of the nation's industrial workforce. We are pleased to present the Association's views on H.R. 6300, the "Tax Compliance Act of 1982".

NAM supports the basic thrus of H.R. 6300 which is to increase taxpayer compliance through the use of improved information reporting requirements and stricter penalties on those who violate the Federal tax laws. In addition, NAM believes that this approach, rather than a broad extension of the mandatory withholding system, is the better way to attempt a comprehensive reform of the voluntary compliance system. NAM is concerned, however, that this Committee not place unnecessary or onerous burdens upon the legitimate business sector of our society. We therefore request that this Committee in its consideration of taxpayer compliance legislation reaffirm the merits of our self assessment system by not penalizing the overwhelming majority of honest businessmen who seek to comply with an ever increasing burden of government reporting. With these thoughts in mind, the NAM believes that this legislation would be more effective if the following provisions were modified or deleted:

SECTION 102—OBLIGATION REQUIRED TO BE REGISTERED

Section 102 of the bill would not permit a deduction for interest paid on any corporate obligation required to be registered and which was not registered. This provision, if enacted, could have serious consequences for Eurodollar debt offerings by U.S. firms. Eurodollar debt offerings are invariably in bearer form and there are few, if any overseas markets for obligations in registered form. Enactment of this provision could close off this important source of capital for U.S. companies. The NAM therefore recommends that this provision be modified to be made inapplicable to those obligations that are offered outside the U.S.

SECTION 122—CIVIL FRAUD PENALTY

Section 122 provides for a new civil penalty to be assessed against any person who aids, assists, etc. in the preparation of a return or other document which the person knows will likely be used in any matter occuring under the tax laws and which the person knows will result in the understatement of tax liability. This $1,000 penalty ($5,000 in the case of returns and documents relating to the tax liability of a corporation) could be imposed whether or not the taxpayer knew of the understatement. This penalty could be imposed in addition to current criminal sanctions for fraudulent preparation of tax documents. While the NAM thinks that this provision is somewhat better than a similar provision in H.R. 5829, we still believe that sufficient penalties exist in current law to deter improper corporate and individual behavior. We therefore recommend that this section be deleted.

SECTION 213—EXTENSION OF WITHHOLDING TO CERTAIN PAYMENTS

Section 213 addresses the issue of a person either refusing to furnish or furnishing an inaccurate taxpayer identification number. Rather than introduce a new burden on the payor by providing for the levying of withholding taxes irrespective of the amount of payment involved where a person refuses to provide his identification number or provides an erroneous number, we suggest this burden be retained where it belongs—on the payee. If the penalty on the payee is insufficient, we suggest the penalty levied against such payee be increased rather than a new burden placed upon the payor.

SECTION 215—PAPERWORK REDUCTION

Section 215 exempts the IRS from the recently passed Paperwork Reduction Act of 1980. The Office of Management and Budget has reported that of the total paperwork burden imposed upon businessmen during fiscal year 1982, almost half (45 percent) will be imposed by the Department of the Treasury. The NAM opposes the total IRS exemption as contrary to the purposes and objectives of the Federal Paperwork Reduction Act which was to control and reduce the Federal paperwork burden. The NAM believes, however, that the IRS should not be subject to OMB review where such review delays the issuance of IRS interpretative rules and regulations.

SECTION 402—TREATMENT OF FOREIGN TRANSACTIONS

Section 402 purportedly attempts to deal with "laundered" cash or misrepresentation of facts. This section is one of the most controversial of H.R. 6300 and should be carefully scrutinized before it is included in final legislation. One of the most acute problems is that of a domestic corporation that would be required to present documentation in the U.S. which under foreign law is not permitted outside the foreign country. This could present a Draconian choice to the business taxpayer who must choose between obeying domestic law or obeying foreign law. The bill also appears to require a U.S. corporation to maintain books and records with respect to its equity ownership in either a wholly owned subsidiary or one in which it holds a 10 percent or more minority interest. This creates added administrative costs if, in fact, the burden can be met especially as to a minority interest held in a foreign corporation. Another potential problem with this section is that it creates substantial presumptions against taxpayers, including legitimate taxpayers, that could be difficult to overcome through no fault of such taxpayers. How, for instance, could a business taxpayer respond to the insistence of an aggressive revenue agent that the general ledger of, say, a Swiss company (which cannot leave Switzerland) be produced in the U.S. for the purpose of substantiating a foreign tax payment or certain expenses of the company which are taken into account in determining the parent company's U.S. tax liability on a dividend received from such Swiss company? While existing law and procedures permit the use of alternative documentation, it appears this section places the legitimate businessman in unnecessary jeopardy by introducing new burdens of proof which such businessman must bear. The NAM recommends continuation of existing law in this area absent a showing of probably tax fraud.

SECTION 411—PENALTY FOR FAILURE TO FURNISH INFORMATION WITH RESPECT TO FOREIGN CORPORATION

Section 411 adds a new fixed dollar penalty for failure to file information returns. The bill would also retain the 10 percent reduction in the foreign tax credit as imposed under IRC Section 6038(b). The NAM believes that the proposed fixed dollar penalty is sufficient to encourage the filing of information returns by controlled foreign corporations and we therefore support its enactment. We do, however, oppose the retention of the present 6038(b) penalty as duplicative, unnecessary and unduly harsh and recommend its deletion from the code.

SECTION 502—RESTRICTIONS ON THE PAYMENT OF INTEREST

Section 502 denies the payment of interest on an overpayment resulting from a net operating loss or tax credit carryback. It also provides that no interest is to be paid on a refund claimed on a return filed after the last date prescribed for filing a return, including extensions of time. We believe the second provision properly attempts to deal with persons who specifically seek to maximize their interest income be deferring the filing of a tax return beyond a return due date, including extensions of time. Alternatively, we strongly oppose the proposal to deny interest because of overpayments resulting from a net operating loss or tax credit carryback. We believe a basic sense of fair play is required by the government in dealing with its taxpayers. Taxpayers required to pay tax on an audit deficiency based on subsequently issued regulations or a subsequently decided court case must pay interest on the deficiency calculated from the date the tax was initially due. To deny taxpayers interest from the first day of the year following the year when a loss or excess credit is created which gives rise to a carryback does not appear evenhanded and, in the context of our current economic situation, could be viewed as equivalent to a tax increase on loss companies. We strongly suggest that this provision be deleted.

SECTION 503—NONDEDUCTIBLE INTEREST SURCHARGE FOR SUBSTANTIAL UNDERSTATEMENT

Section 503 provides for a no-fault, non-deductible surcharge due to a substantial understatement of tax. A substantial understatement is defined as one that is at least 10 percent of the taxpayer's actual tax liability and $5,000 or at least 50 percent of the actual tax liability and $500. While this provision is preferable to the penalty and burdensome disclosure provisions of H.R. 5829, the NAM believes that this section is unwarranted and that its penalty provisions are unduly harsh. The NAM is strongly opposed to the section because we believe that the self-assessment system has worked to a significant degree and the system is undermined by a no-fault provision that penalizes taxpayers who make a good faith effort to comply with the law. Our tax laws are exceedingly complex and give rise to a substantial amount of uncertainty. In addition, many corporate taxpayers, especially those involved in international business and/or having a multitude of U.S. locations, cannot be expected to conduct internal tax audits of their financial books of account prior to filing tax returns by the prescribed due dates. At this time of significantly reduced business income, the threshold amounts may provide little solace to business taxpayers. The fact that the Secretary may chose to waive this penalty is not an adequate substitute for the rule of law—or good tax policy. We therefore recommend the deletion of this section.

In conclusion, the National Association of Manufacturers firmly believes that the citizens of our country, be they individual or corporate, have a responsibility to comply with the tax laws of this country. We appreciate the need, in certain cases, to strengthen the reporting requirements of existing law and believe the majority of our members would be willing to absorb a reasonable increase in government reporting to assure the evenhanded application of our tax laws.

We ask this Committee, however, not to place unwarranted or onerous burdens upon the business community in seeking to achieve these goals. We particularly ask this Committee: (1) to reject the levying of no-fault penalties against taxpayers: (2) not to deny interest to taxpayers where the government has had the use of their money; (3) not to place U.S. companies doing business abroad or seeking to borrow abroad in untenable or non-competitive positions; (4) any new penalties levied for failure to report information be on those who refuse to provide accurate information as to their identification, rather than on those with whom they do business.

Thank you, Mr. Chairman, for the opportunity to present our views at this hearing. We look forward to working with you in the coming weeks.

Mr. GUARINI. Thank you, Mr. Rau.

Our next witness will be Mr. Monty Barber, representing the Direct Selling Association.

STATEMENT OF MONTY BARBER, VICE CHAIRMAN OF THE BOARD, DIRECT SELLING ASSOCIATION, AND VICE PRESIDENT AND GENERAL COUNSEL, MARY KAY COSMETICS, ACCOMPANIED BY NEIL OFFEN, PRESIDENT; JOHN BEYER, PRESIDENT, ROBERT R. NATHAN ASSOCIATES; AND ARTHUR J. ROTHKOPF, COUNSEL

Mr. BARBER. Thank you, Mr. Chairman. I am vice chairman of the board of directors of the Direct Selling Association, which I will refer to in my testimony as DSA. I am also vice president and general counsel of Mary Kay Cosmetics. With me today on my immediate right are Neil Offen, president of DSA; on his right, Art Rothkopf of the Washington law firm of Hogan and Hartson; behind us is Mr. John Beyer, who is president of Robert R. Nathan Associates.

We appreciate this opportunity to testify today on H.R. 6300, the Tax Compliance Act of 1982 and related legislation, and ask that our previously filed statement be made a part of the record.

For the reasons I will mention, DSA strongly opposes the enactment of those provisions of H.R. 6300 that would impose special reporting requirements on direct sellers, and would require backup withholding on buy-sell and deposit-commission direct sellers.

We believe that by including only compliance provisions relating to direct sellers and independent contractors in H.R. 6300, the legislation makes a serious error. It is unwise in our view to try to deal with the numerous and complex issues involved with the independent contractor taxation by legislating on only one aspect of the questions involved. Rather, we believe the issues involved in this should be addressed comprehensively and as a part of an overall resolution of the substantive, procedural and compliance issues involved in this area of the tax law. Only through this comprehensive approach can there be a permanent resolution of the controversy that has plagued this area for years.

For at least the past 4 or 5 years, Congress and the industries using independent contractors have sought to resolve the thorny issues relating to the classification of independent contractors, as well as related compliance and procedural issues.

Congress has considered this problem to be so serious that it has placed a moratorium on IRS actions in this area, pending congressional action. The latest moratorium will expire on June 30 of this year. Several bills have been introduced in this Congress to resolve the classification issue through definitional safe harbor legislation, with compliance measures forming part of such legislation. Most recently, H.R. 6311, a bipartisan bill, was introduced by Congressmen Gephardt and Conable to resolve the classification procedural and compliance issues in a constructive and equitable manner. Chairman Stark has just announced a hearing of the Subcommittee on Select Revenue Measures on June 11 to consider this and other legislation.

We strongly believe that the Select Revenue Subcommittee is the proper forum for considering the interrelated issues involving independent contractors, and urge that all independent contractor compliance provisions be deleted from H.R. 6300 for appropriate consideration by the Select Revenue Subcommittee, or alternatively that the provisions of H.R. 6311 be substituted for those sections of 6300 dealing with independent contractors and direct sellers.

DSA believes that H.R. 6300 is deficient by including compliance provisions relating to direct sellers that are completely arbitrary and unrealistic, as well as discriminatory against direct selling. These compliance measures are costly to the industry, will not work and are likely to be counterproductive.

One of the provisions of 6300 which would require companies operating on a buy-sell basis to furnish gross sales data would result in added burdens and costs that cannot be justified by any additional revenue that might be achieved.

The second of these provisions would require backup withholding on buy-sell transactions. This provision is totally absurd in that it would require withholding in a transaction in which no funds moved from the payor to the payee. It is simply a purchase transaction. No similar transaction in the entire economy would be treated in this manner.

An economic study performed by Robert R. Nathan Associates revealed that with net income of all direct salespeople of $1.3 billion, the total unpaid taxes for all direct sellers is only $35 million, and that number may well be overstated.

Assistant Secretary of the Treasury Chapoton's testimony before the Senate Finance Committee on April 26 confirmed the Nathan firm's estimate that 85 percent of taxes owed by independent contractors and direct sellers had been paid. This Treasury-admitted compliance rate, which rate is considered too low by us, results in an average potential unpaid tax of less than $9 per direct salesperson.

Given this nominal potential loss of revenue, we are at a loss to understand why such an unwieldly and oppressive compliance apparatus is being considered in H.R. 6300 that is directed solely as direct sellers.

Moreover, H.R. 6300 does not even address the most urgent question of the classification of independent contractors. We consider it essential that the classification question be resolved on a permanent basis as part of an overall resolution of the independent contractor question.

Consequently, DSA strongly supports the enactment of H.R. 6311, the legislation recently introduced by Congressmen Gephardt and Conable. This legislation deals with the issue in a comprehensive and responsible fashion. It combines a reasonable safe harbor classification provision with compliance measures which, while they would impose substantial reporting burdens on our industry, would be acceptable as part of an overall solution of the issue. We urge that this committee promptly consider and report favorably on H.R. 6311, either separately or as a substituted part of H.R. 6300.

Thank you.

[The prepared statement follows:]

Statement of the Direct Selling Association as Presented by Monty Barber

SUMMARY

DSA is a trade association representing 115 direct selling companies and another 105 firms that supply goods and services to direct sellers. Companies within the industry market a wide variety of consumer products and services. In any given year, over four million people engage in direct selling in the United States, with at least two million active in the business at any given time. Because of the independent contractor relationship, direct selling is a field open to everyone, with virtually no barriers to entry. Eighty percent of direct sales people are women. During any year, more than 600,000 are minorities, 200,000 are over 65, and 400,000 have disabilities. The overwhelming majority (89 percent) work part-time, and nearly two-thirds work less than ten hours per week.

Independent contractor status is absolutely fundamental to the structure of the direct selling industry. Direct sellers have traditionally met the common law test and have been treated by the courts as independent contractors, with the key test case being *Aparacor, Inc., v. U.S.,* 556 F.2d 1004 (Ct. Cl. 1977).

Direct selling has a long history of cooperation with the IRS to encourage voluntary tax compliance, with direct sales companies supplying extensive information to their independent contractors concerning their Federal tax obligations and proper deductions. Those individuals engaged in direct selling have an excellent tax compliance record.

DSA favors deletion of the independent contractor compliance provisions from H.R. 6300, and favors enactment of H.R. 6311, a bipartisan measure introduced by Congressmen Gephardt and Conable, which deals comprehensively with all aspects of the independent contractor issue, including tax compliance.

a. Independent contractor compliance provisions should be stricken from H.R. 6300. Hearings on H.R. 6311 and other broad-based bills dealing with independent contractors are being held on June 11 by the Select Revenue Subcommittee. The issues involved in independent contractor taxation should be addressed as part of an overall resolution of the substantive, procedural and compliance issues involved in this area of the tax law.

b. The compliance provisions in H.R. 6300 relating to direct sellers are completely arbitrary and unrealistic, as well as discriminatory against direct selling. These compliance measures are costly to the industry, will not work and are likely to be counterproductive. The proposed withholding penalty is absurd since there are no payments to buy-sell direct sellers in which to withhold. An economic study performed by Robert R. Nathan Associates reveals that with net income of all direct sales people of $1.3 billion, the potential unpaid taxes for *all* direct sellers in only

$35 million, and this number may well be overstated. This is based on the IRS' own compliance study. Given this nominal loss of revenue, we cannot understand why such an unwieldly and oppressive compliance apparatus is aimed soley at direct sellers in H.R. 6300.

c. DSA strongly favors enactment of H.R. 6311. This legislation combines a reasonable safe harbor classification provision with compliance measures which, while they would impose substantial burdens on our industry, would be acceptable as part of an overall solution of the issue.

STATEMENT

Mr. Chairman and Members of the Committee: My name is Monty Barber. I am Vice Chairman of the Board of Directors of the Direct Selling Association (DSA) and Vice President and General Counsel of Mary Kay Cosmetics, Inc. With me today are Neil H. Offen, President of DSA, John C. Beyer, President of Robert R. Nathan Associates, Inc., and Arthur J. Rothkopf of the Washington law firm of Hogan & Hartson, who serves as tax counsel to the Association.

We appreciate the opportunity to testify today on H.R. 6300, "The Tax Compliance Act of 1982" and related legislation. For the reasons set forth in detail below, DSA strongly opposed the enactment of those provisions of H.R. 6300 that would impose special reporting requirements on direct sellers and would require "back-up withholding" on buy-sell and deposit-commission direct sellers. We believe that by including compliance provisions relating to direct sellers and independent contractors in H.R. 6300, the legislation makes a serious error. It is unwise in our view to try to deal with the numerous and complex issues involved with independent contractor taxation by legislating on only one aspect of the questions involved. Rather, we believe that the issues involved in independent contractor taxation should be addressed comprehensively and as part of an overall resolution of the substantive, procedural and compliance issues involved in this area of the tax law. Only through a comprehensive approach can there be a permanent resolution of the controversy that has plagued this area.

For several years, Congress and the industries using independent contractors have sought to resolve the thorny issues relating to the classification of independent contractors, as well as related compliance and procedural issues. Congress has considered this problem to be so serious that it has placed a moratorium on IRS action in this area, pending Congressional action. The latest moratorium will expire on June 30 of this year. Several bills have been introduced in this Congress to resolve the classification issue through safe harbor legislation, with compliance measures forming part of such legislation. Most recently, H.R. 6311, a bipartisan bill was introduced by Congressmen Gephardt and Conable to resolve the classification, procedural and compliance issues in a constructive and equitable manner. Chairman Stark has just announced a hearing of the Subcommittee on Select Revenue Measures on June 11 to consider this and other legislation. We strongly believe that the Select Revenues Subcommittee is the proper forum for considering the interrelated issues involving independent contractors, and we urge that all independent contractor compliance provisions be deleted from H.R. 6300, for appropriate consideration by the Select Revenues Subcommittee.

DSA believes that H.R. 6300 is deficient by including compliance provisions relating to direct sellers that are completely arbitrary and unrealistic, as well as discriminatory against direct selling. These compliance measures are costly to the industry, will not work and are likely to be counterproductive. An economic study performed by Robert R. Nathan Associates reveals that with net income all direct salespeople of $1.3 billion, the potential unpaid taxes for all direct sellers is only $35 million, and this number may well be overstated. Given this nominal potential loss of revenue, we are at a loss to understand why such an unwieldy and oppressive compliance apparatus is being constructed in H.R. 6300 that is directed solely at direct sellers.

Moreover, H.R. 6300 does not even address the most urgent question of the classification of independent contractors. We consider it essential for the classification question to be resolved on a permanent basis as part of an overall resolution of the independent contractor question. Consequently, DSA strongly supports the enactment of H.R. 631, the legislation recently introduced by Congressman Gephardt and Conable. This legislation deals with the independent contractor issue in a comprehensive and responsible fashion. It combines a reasonable safe harbor classification provision with compliance measures which, while they would impose substantial burdens on our industry, would be acceptable as part of an overall solution of the issue. We urge that this committee promptly consider and report favorably on H.R. 6311.

The direct selling industry

The Direct Selling Association is a trade association representing 115 direct selling companies and another 105 firms that supply goods or services to direct selling companies. In addition, more than 4 million independent salespeople who market the products of direct selling companies are affiliate members of DSA. Direct selling is a method of distribution through which products and services are marketed directly to consumers in their homes. Companies within the industry market a wide variety of consumer products and services: household cleaning products, cosmetics and othe personal care products, jewelry, cookware and other housewares, educational materials, home improvement products and services, food, vitamins, and so forth. The majority of companies within the industry qualify as small businesses. In 1980, total industry sales approximated $7.5 billion at retail.

But more important than the characteristics of the direct selling companies are the characteristics of the individual entrepreneurs who do business with the companies. There are virtually no barriers or requirements for entry into direct selling. It is a field open to any American. It provides flexible income-earning opportunities. For example, there are no demands that direct salespeople spend a given number of hours or sell at any particular time. For those reasons, direct selling has wide appeal among women who have significant family responsibilities.

The flexibility of the industry and ease of entry also attract substantial numbers of minorities, the handicapped, and the elderly. In any year, over four million people engage in direct selling in the United States, with at least two million active in the business at any given time. Eighty percent of direct salespeople are women. Further, during any year, more than 600,000 are minorities, 200,000 are over 65, and 400,000 have disabilities. The overwhelming majority of these salespeople—89 percent—work at part-time and nearly two-thirds work less than ten hours per week.

For most direct salespeople, selling is not seen as a "job" but as an additional earning opportunity—a way for many people with modest or fixed incomes to supplement their earnings and make ends meet. Many direct salespeople sell intermittently and for different companies, establishing short-term specific earning goals and then terminating their sales activity when the goals are met. This way of doing business, which is foreign to an employer-employee relationship, helps to account for the industry's high turnover rate, which is in excess of 100 percent each year.

Simply stated, direct selling is an ideal way for some of these people to earn extra money without past business experience, without substantial capital, and without having to make a full-time commitment to an employer. Direct selling is also an excellent way for individuals to establish full-time career opportunities after first working on a part-time basis. Those who devote more time will obviously earn more from direct selling. This, 10 percent of those engaged in direct selling earn 63 percent of total income.

The role of independent contractors in direct selling

The people who sell the products of direct selling companies have traditionally operated as independent contractors for reasons that are fundamental to the structure of the industry. The motivation of direct salespeople is directly related to the fact that they in effect have their own business: they control the hours they work, they conduct business awasy from any office or other fixed location, they keep their own records and books, frequently they maintain their own inventories, and they pay their own expenses. Direct salespeople are, by any objective assessment, independent businesspeople and operate in the same fashion as retailers throughout the country, except for the fact that they bring their products to the home of the consumer and do not operate from any fixed retail location. They do not perceive themselves as employees, nor do they wish to be so treated. They generally sell to their peers within their own communities, to their friends and neighbors. Each year they contact three out of every four homes in America. According to a Lou Harris study, 8 percent of the homes in this nation today include someone who will be a direct salesperson during the year, and an additional 15 percent of America's homes have someone in the home who had previously acted as a direct salesperson.

The independence of the operations of direct salespeople is a crucial factor in the decisions of individuals to become direct salespeople. Our Lou Harris study of direct salespeople found that they rated their own independence, being their own bosses, as the most important element of their sales work, even more important than the specific income they received, which was a close second. This person who sees himself or herself as an independent businessperson is the heart of the direct sales industry.

The success of direct selling companies is a function of the size and capability of their sales forces. Each company strives to expand its sales force, and competition among direct sales companies for salespeople is keen. Consequently, direct selling companies minimize their additional fixed costs for increasing the size of their sales force and create wide opportunities for marginal workers to enter direct selling. The increased size of the sales force and the minimal administrative costs associated with adding salespersons are key economic factors in the growth of direct selling. The independent contractor relationship is crucial to minimizing personnel costs and maximizing opportunities available. The relationships between direct selling companies and their salespeople are also extremely sensitive, especially with new recruits. Experience within the industry demonstrates that changing any aspects of these relationships or imposing additional administrative or other burdens will produce severe adverse consequences to the industry.

The use of independent contractors is fundamental to the structure of the direct selling industry. For tax purposes the Internal Revenue Code has long respected this status of independent contractors as determined under the common law. Traditionally, in the direct selling industry the tests for that status imposed by the common law were clearly met, and direct salespeople were treated as independent contractors for tax purposes without substantial dispute.

However, during the 1970's the Internal Revenue Service adopted an increasingly aggressive and unjustified audit position of challenging the independent contractor status of a broad group of individuals, including some direct salespeople. The most prominent example, and the test case, in the direct selling industry involved Queen's-Way to Fashion, Inc., a direct selling company subsequently renamed Aparacor, Inc. The IRS challenge culminated in a decision by the U.S. Court of Claims (*Aparacor, Inc. v. United States*, 556 F.2d 1004, 1977). In that case the Court sustained the independent contractor status of the direct salespeople and stated that the IRS assessment "represents a radical departure from the traditional common law concept" (556 F.2d at 1012). While the company won the case, it was a costly victory; the company's growth and development were set back for years pending the outcome of the litigation.[1]

The unjustified attacks on the independent contractor status of direct salespeople illustrated in the *Aparacor, Inc.* case can not only immobilize a company's operations, but also create huge retroactive assessments which can jeopardize the financial well-being of a direct selling company. In challenging a company's treatment of individuals as independent contractors, the IRS assesses the company for the full amount of income taxes which it asserts should have been withheld were all its independent contractors treated as employees, plus both the employee and employer share of FICA taxes and FUTA taxes. These amounts have been assessed in many cases even though the individual treated as an independent contractor has in fact paid the full amount of income taxes and self-employment taxes which he or she owed. In these cases, the IRS assessments have resulted in double tax, since income taxes for the same individual would both be paid by that individual and the company, and similarly both FICA and self-employment taxes would be paid. In order for the company to reduce this double tax, it has the burden of locating its reclassified independent contractors and obtaining from them information regarding their tax payments; the IRS refuses to assist the companies in this regard.

Fortunately for the direct selling industry and its independent contractors, the IRS has had no success in attempting to reclassify direct salespeople as employees. However, continued IRS excesses in seeking to reclassify independent contractors generally led to the enactment of § 530 of the Revenue Act of 1978, which placed a moratorium on IRS enforcement and regulatory activities in the independent contractor area, pending action by Congress.

Since the enactment of § 530 and through the period covered by the two extensions, DSA has encouraged the Congress to enact reasonable safe-harbor standards for determining the status of independent contractors. Direct selling companies believe that the enactment of a reasonable safe-harbor, provided that the common law is available in the event that the safe-harbor is not satisfied, would be a major step forward in helping to resolve the expensive and prolonged controversies that have arisen over who is or is not an independent contractor.

---

[1] A second case, involving Beeline Fashions, Inc., was subsequently settled to the company's satisfaction, permitting the company to continue its previously established independent contractor treatment of its salespeople.

Tax compliance of direct sellers

The direct selling industry believes that those individuals engaged in direct selling have an excellent tax compliance record. On both an ethical as well as legal basis, direct salespeople, like other self-employed taxpayers, should pay their taxes and report proper business deductions, and we are convinced that they do so.

Our industry has had a long history of cooperation with the Internal Revenue Service to encourage voluntary compliance on the part of direct selling companies and their salespeople. Over the past ten years, many meetings have been held with Internal Revenue Service personnel, almost invariably at the instance of DSA, to determine additional ways in which the compliance levels of those engaged in direct selling could be improved. These efforts on the part of the industry have not gone unnoticed, as reflected in a letter, dated October 17, 1977, from the Office of the Commissioner of the Internal Revenue Service, which acknowledged "a history of concern and cooperation on the part of the Direct Selling Association with the Internal Revenue Service in our cooperative efforts to promote voluntary compliance." These efforts over a period of many years have borne fruit in an extensive educational program engaged in by direct selling companies to assist and encourage their salespeople to fully and accurately report their income and deductions attributable to direct selling. DSA's member companies have an excellent record of distributing to their salespeople detailed information on a frequent basis that explains to the salespeople their federal income and employment tax responsibilities. This written material demonstrates a real concern on the part of the companies for tax compliance, which we believe is reflected in an excellent compliance record on the part of those who are engaged in direct selling.

In 1979, the Internal Revenue Service prepared a study which purported to show that independent contractors in general, including direct sellers, had low levels of tax compliance. Robert R. Nathan appeared before this Committee in 1979 and presented a detailed assessment prepared by his firm which demonstrated the fundamentally flawed manner in which this IRS study was conducted. His conclusion then, as it remains today, was that the IRS study was so deficient in design that no meaningful conclusions should be drawn concerning compliance of independent contractors generally and of direct salespersons in particular. I think it should be noted that it is highly doubtful that the direct selling industry was appropriately represented in the study, and, in fact, no member company of DSA is aware of any of their direct salespersons who were incorporated in the study. (See Attachment 1.)

Notwithstanding the absence of any credible, objective data, IRS officials continue to claim that independent contractor and direct selling tax compliance is poor. We completely reject that conclusion. For example, even assuming for purposes of analysis that the results of the 1979 IRS study were correct (which we do not accept), the Nathan firm has estimated (based on that IRS study) that 85–90 percent of the taxes owed by independent contractors and direct sellers were paid. The accuracy of this estimate was confirmed in Assistant Secretary Chapoton's testimony before the Senate Finance Committee on April 26, 1982 (at p. 2).

Because of this compliance record, I and others in the direct selling industry are deeply disturbed by the effort of the IRS to link direct salespersons and the so-called "underground economy" or the "tax compliance gap." To associate in any way direct salespersons as being a major factor in the IRS's estimate of $26 billion of unpaid taxes by self-employed persons is completely inappropriate. In response to our concern, Robert R. Nathan Associates has undertaken further analysis to determine total unpaid taxes for a recent year for all direct salespersons. The results of this analysis, based on data for 1980, show potential unpaid taxes for all direct salespersons of only $35 million, and, in fact, we believe that this number overstates unpaid taxes. (See Attachment 2.) Given the size of the industry, the number of people engaged in direct selling and net income of all direct salespeople of $1.3 billion, this possible unpaid tax figure is truly a nominal one. Moreover, through the new compliance measures in H.R. 6311 and industry initiatives in taxpayer education, it is expected that this nominal figure will be reduced even further in the future.

H.R. 6300

DSA does not believe that the compliance aspects of the independent contractor issue should be dealt with apart from resolution of the classification issue. We consider the classification issue to be a critical one that should be resolved in conjunction in conjuction with all other independent contractor tax questions. Therefore, we urge that the independent contractor compliance aspects of H.R. 6300 be deleted from the legislation and be considered at the same time as H.R. 6311.

In reviewing the provisions of H.R. 6300 and its implications for direct sellers, there are two provisions that DSA strenuously opposes. These provisions call for: 1. information reporting to the Internal Revenue Service by any person selling products on a buy-sell or deposit-commission basis to a buyer who in turn sells such products on a direct sale basis, where the aggregate amount of sales during the year is $600 or more (§ 203 of the bill); and 2. subjecting buy-sell and deposit-commission direct sale transactions to be "back-up withholding" provisions of the bill in those cases in which no taxpayer identification number or an incorrect number is given to the seller of the merchandise (§§ 203 and 213 of the bill).

Information Reporting.—Under present law, a payor is required to report to the Internal Revenue Service and the payee remuneration paid in the form of commissions, bonuses, etc., of $600 or more. Direct sales companies supply such forms to their salespeople as required under present law. The proposed legislation would impose a new requirement in those cases in which the direct salesperson purchases goods on a buy-sell or deposit-commission basis and would require that the company or individual selling to the direct seller report to the IRS where sales to that individual amounted to $600 or more during the year.

DSA has strongly opposed enactment of reporting provisions that would require companies operating on a buy-sell basis to furnish gross sales data on the grounds that the added burden and costs resulting from this additional information reporting cannot be justified by any additional revenue that might be achieved. Gross sales data produces no information that is directly related to the net income of the individual salesperson. The Internal Revenue Service would have no information concerning the resale price of the products purchased nor any information concerning the expenses of the individuals. Moreover, many direct sellers retain a high proportion of the products they purchase for personal use. Industry-wide data on personal purchases reflect wide variations for different companies, with the average figure for all direct selling companies approximating 25 percent of purchases. In some instances, purchases for personal use exceed 50 percent. For these reasons, the Revenue Service will be unable to use the aggregate sales data provided by the companies to calculate an individual's net income from direct selling.

The costs of administering this new recordkeeping requirement will be quite expensive to some direct selling companies and will impose a particular burden in the case of multi-level operations, since the reporting burden will fall entirely on those small business people who are distributors. In light of the nominal potential revenue loss from direct selling (maximum of $35 million), there is absolutely no justification for imposing any new reporting burden, except as part of the more realistic, though burdensome, reporting provision included as an essential element of the overall resolution of the issue provided in H.R. 6311. We consider this new reporting requirement to be particularly discriminatory, since direct sellers would be subject to this requirement on net income representing a small fraction of the $600 income applicable to all other industries. We cannot comprehend why reporting is being required of others at the $600 level of compensation, while direct sellers are being subjected to this onerous new reporting burden even though gross income (after taking personal use and cost of goods sold into account) would likely be a minor percentage of $600.

"Back-up Withholding" on Buy-Sell Transactions.—H.R. 6300, as does H.R. 5829, would establish a new back-up withholding system in those cases in which a payee does not give a taxpayer identification number to a payor or gives an incorrect taxpayer identification number. While DSA has concerns about the imposition of withholding on independent contractors in any circumstances, we would not object to withholding on payments made by a payor in those instances in which either no taxpayer identification number or an incorrect number is provided, and notice is given to the payee with the opportunity to supply a proper identification number.

However, section 203 of H.R. 6300 states that in the case of a buy-sell or deposit-commission direct sale, the seller shall be treated as having made a payment to the buyer in an amount equal to the amount at which the sale takes place (thereby subjecting such a transaction to the back-up withholding provisions). Thus, by a stroke of the pen, a transaction in which money actually flows from the buyer of merchandise to the seller is converted into a hypothetical one in which the seller somehow transfers funds to the buyer. This is a totally absurd position.

How can withholding apply to a transaction in which no funds move from the payor to the payee? If the back-up withholding provisions were to apply, where will the seller obtain the 10 percent to pay the withholding tax? We are aware of no similar transaction in the entire economy which is treated in this manner and we believe it to be totally unjustified. We would point out that even H.R. 5867 (based on H.R. 5460 of the last Congress), which seeks to impose withholding on payments to independent contractors, provides an exemption from withholding for buy-sell and deposit-commission direct sales. There can be no doubt that this application of the back-up withholding provisions to buy-sell direct sellers is completely unworkable, without justification and should be deleted from the bill.

H.R. 6311

Safe-Harbor Provisions.—The Direct Selling Association strongly supports the enactment of the classification provisions of H.R. 6311. It is our belief that this bill deals with the independent contractor classification question in a judicious and reasonable manner by establishing a safe-harbor to provide certainty for the Government, direct selling companies and individual independent contractors. The legislation was carefully drafted to permit traditional independent contractors to continue in that status without fear of harassment from the Internal Revenue Service. Those industries that are unable to meet the safe-harbor standards of this legislation would continue to be judged under the traditional common law standards. The legislation would have the effect of eliminating a great deal of the controversy that has characterized this issue prior to the enactment of section 530 in 1978.

The bill would require that persons seeking to take advantage of the safe-harbor meet both a control-of-hours test and a place-of-business test, and in addition, satisfy either an investment or income fluctuation test. These factors are the key elements of the traditional common law requirements for independent contractor status, and therefore, appropriately form the basis for a safe-harbor standard. In addition, H.R. 6311 requires that a written contract be entered into between the independent contractor and the company for whom the services are performed, and that the independent contractor be furnished a written notice of his or her tax responsibilities at the time the contract is executed. Moreover, in order for the safe-harbor test to apply, all required information returns would have to be filed. We believe that this legislation represents a fair and workable effort to prescribe the most significant standards in determining whether an individual is an independent contractor.

We must emphasize, however, that the support of DSA for the classification provisions of S. 2369 is based on its safe-harbor approach. DSA would oppose this or any other bill which would replace the common law with a specified statutory test or presumption. By preserving the common law means for attaining independent contractor status, the bill retains the flexibility that the common law provides—so that new companies and new ways of doing business can be accommodated as they arise. This flexibility is, in our view, crucial to any status determination for tax purposes and is important to the well-being of our economy.

We thus support the classification provisions of H.R. 6311 because it permits those companies desiring certainty against IRS challenge to have that certainty if its safe-harbor requirements are met. At the same time, the bill avoids forcing companies and independent business people into arbitrary and restrictive methods of operation in order to remain independent contractors. Moreover, the legislation will free IRS personnel from pursuing classification issues and permit them to focus their attentions on non-filers and those filing fraudulent returns.

Compliance Provisions.—H.R. 6311 contains various provisions designed to improve tax compliance among independent contractors. While we have concerns about certain of these provisions, we are most encouraged by the fact that they seek to deal with the subject of improved tax compliance without resorting to the requirement of withholding on independent contractors, except in the limited case in which an independent contractor fails to furnish a taxpayer identification number or furnishes an incorrect number. H.R. 6311 provides for much stricter penalties than under current law for the failure to provide to the Internal Revenue Service information returns on payments to independent contractors and for the failure to provide copies of such returns to the independent contractor.

The compliance provisions of H.R. 6311 will be most burdensome in requiring that an annual report be filed by direct sellers reflecting sales of products for resale in the home to any buyer on a buy-sell or deposit-commission basis, where the amount of sales to a particular buyer during the calender year is $5,000 or more. This reporting requirement would be in addition to the existing requirement that information returns be filed on remuneration paid in excess of $600 during the calendar year. In the alternative, the bill would permit an election by a direct seller to furnish more information on commissions, sales bonuses and other remuneration paid (by reducing the threshold for reporting such remuneration from $600 to $50) and by furnishing certain information identifying those individuals purchasing goods for resale in excess of $1500 during the year.

As discussed above, DSA has in the past strongly opposed the enactment of reporting provisions that would require companies operating on a buy-sell basis to furnish gross sales data. However, notwithstanding the severe reservations which DSA has about the adoption of specific new information reporting requirements solely on direct sellers, DSA supports the direct sales reporting requirements of H.R. 6311 in order to achieve a final resolution of the classification issue. We wish to emphasize that we are willing to support these new reporting requirements in deference to the good faith efforts of Congressmen Gephardt and Conable to find an overall solution to the complex problems inherent in the independent contractor issue. We should note that to some direct selling companies the gross sales reporting method of the bill would be preferable because of the extreme reporting burden of reporting remuneration at the $50 level. Other companies, because of their structure, would prefer the reduced Form 1099 reporting alternative. Therefore, there is need for an alternative reporting system and maintaining this option is critical. In summary, the new reporting system will be expensive and painful to many of our companies, but we can support it provided that (1) the alternative approach of the bill is retained and (2) the provision is included as part of a safe-harbor classification bill along the lines of H.R. 6311.

CONCLUSION

DSA strongly opposes enactment of those provisions of H.R. 6300 that deal with independent contractor compliance and urges that these provisions be considered as part of the independent contractor issue as a whole. The entire range of independent contractor issues will be the subject of a hearing of the Select Revenues Subcommittee to be held on June 11. In this regard, DSA strongly endorses the legislation recently introduced by Congressmen Gephardt and Conable, H.R. 6311, which provides a constructive and equitable solution to the classification issue, as well as the procedural and compliance questions.

DSA is particularly distressed at the two provisions contained in H.R. 6300 which are aimed at direct sellers and which are discriminatory, arbitrary and unrealistic. First, the proposed requirement of information reporting on buy-sell transactions of $600 or more a year would create a burdensome and costly new reporting requirement with little or no benefit to the Government. Second, the provision of H.R. 6300 that would subject buy-sell transactions to the back-up withholding system defies all logic. It would require withholding under circumstances in which there are no funds to withhold upon.

DSA strongly urges that the Congress deal promptly and comprehensively with the independent contractor issue by enacting H.R. 6311 prior to expiration of the § 530 moratorium on June 30. This legislation seeks to resolve the numerous issues involved in a responsible fashion, taking into account both the interests of the Government and interested taxpayers. We believe that it is possible to put the independent contractor controversy to rest and we urge that Congress do so by enacting H.R. 6311.

RRNA
CONSULTING ECONOMISTS

Attachment 1

DEFECTS IN THE IRS COMPLIANCE STUDY

The Treasury proposal to extend tax withholding to independent contractors is based on an IRS compliance study of 5,152 individuals which concludes that tax compliance for independent contractors is poor. This study and the conclusions drawn from it are too seriously flawed to serve as the basis for such a fundamental tax change.

The IRS Failed to Estimate Compliance Rates Correctly

- The IRS failed to compare taxes paid on independent contractor income to total taxes owed. Using the IRS's own data for the 5,152 workers in the study, it is estimated that 90% of the taxes owed on this income have been paid. Failure to measure this most basic and meaningful compliance rate is a serious flaw in the IRS study.
- The IRS failed to utilize net income as the most appropriate measure for calculating compliance rates, resulting in an overstatement of non-compliance.
- The IRS failed to include in the compliance estimates individuals whose total income was below the level of that required for filing returns. This resulted in further overstatement of non-compliance.
- The IRS failed to measure tax compliance where information returns (Forms 1099) are furnished to independent contractors. Such a correlation would have indicated whether better information reporting would lead to increased compliance.
- The IRS included as non-compliers a large number of workers (estimated to be almost 20% of the sample) whom the IRS found had no tax liability as independent contractors.

Even The IRS Data Demonstrate That Additional Revenue From Tax Withholding Will Be Small

- The Treasury has stated that withholding and strengthened information reporting would raise the tax compliance rate to approximately 90%, but the IRS study supports the conclusion that the tax compliance rate for independent contractors is already at that level.

- The IRS study shows that additional revenue would come from a very small proportion of independent contractors.
  - Two-thirds of the audited workers had no unpaid taxes.
  - Four-fifths had an average unpaid tax of only $8.32.
  - Fourteen percent of the audited workers account for 87 percent of the unpaid tax.

The Overall Design Of The Study Is Highly Deficient

- The sample of individuals audited is not representative of independent contractors.
  - The universe of independent contractors is not known, which the Treasury explicitly admits.
  - The sample of workers was drawn only from tax cases where employment status was under dispute.
  - The sample of audited workers was drawn from a larger sample which the Treasury has stated is not representative of independent contractors.
    - Over one-third of the workers were drawn from insurance salespersons, which does not reflect the composition of the independent contractor population.
    - The "Direct Sales" category includes workers with occupations foreign to the industry -- entertainers, drivers and a large number of unskilled laborers.
  - The sample was not random. Over 21 percent of the original sample could not be located and was not replaced, contributing to sample bias.
  - The large number of skilled and unskilled workers in the sample (almost one-half) is not consistent with the known characteristics of independent contractors.

- Acceptable measures of statistical reliability have not been provided, so that the reliability of the compliance rates are not known.

  For many industry and occupational groupings in the study, the number of workers audited is too small to estimate compliance with statistical reliability.

RRNA
CONSULTING ECONOMISTS

Attachment 2

AN ESTIMATE OF UNPAID TAXES OF DIRECT SALESPERSONS IN 1980*

Retail sales	$7,500 million
less: personal use	1,837 million
Salespersons' business receipts	5,663 million
less: cost of sales	3,933 million
Salespersons' gross income	1,730 million
less: business deductions	433 million
Salespersons' net income	1,297 million
Salespersons' tax liability	233 million
Unpaid tax	35 million

*This estimate is based on:

(1) Personal use of 24.5 percent of retail sales determined from industry survey.

(2) Average markup over wholesale of 44 percent determined from industry survey.

(3) Assumption of business expenses at 25 percent of gross income.

(4) Average marginal tax rate of 18 percent, determined from data in IRS, Statistics of Income Bulletin and based on average total household income of direct salespersons.

(5) Assumption of tax compliance rate of 85 percent based on 1979 IRS Compliance Study.

Mr. GUARINI. Thank you, Mr. Barber.

Our next witness is Mr. Andre Maisonpierre of the Alliance of American Insurers.

STATEMENT OF ANDRE MAISONPIERRE, SENIOR VICE PRESIDENT, ALLIANCE OF AMERICAN INSURERS

Mr. MAISONPIERRE. Thank you, Mr. Chairman. We have abbreviated our statement and we would appreciate it if it could be made a part of the full record.

Mr. GUARINI. It so will.

Mr. MAISONPIERRE. Thank you.

Our testimony today will address two issues: modification of interest payments in the case of carrybacks, and notification by property and casualty insurers of casualty loss reimbursements.

First, modification of interest payments in the case of carrybacks. H.R. 6300 and H.R. 5289 would substantially delay the Government's obligation to pay interest on carrybacks. Under present procedure, such interest becomes payable from the first day of the taxable year. Such postponement would take effect immediately and would impact taxable year 1981.

We believe that postponing the Government's interest obligation provides for unjust enrichment of Government and penalizes the taxpayer. From an insurance standpoint, the penalty would be inevitable, since the Code makes it impossible for insurance taxpayers to file early in the year. The Code requires that property and casualty insurers develop their Federal tax returns from data which are taken off the company's annual statements filed with the respective State insurance regulators. Completion of the annual statements must await the reporting of all transactions completed through December 31 of the taxable year. Even under the best of circumstances, delays must be anticipated.

The present law is fair to both Government and taxpayers. It should not be tampered with. However, if Congress is of the mood to limit the interest payments on carrybacks, it is suggested that for future years, and I emphasize "future year", beginning in 1983, the law be amended to provide that interest shall be payable upon an application filed with the Government or on the due date for the taxable year, whichever comes first. This would combine the proposals being advanced by H.R. 6300 and H.R. 5829.

With respect to taxable year 1981, there definitely should be no change in the law. Note that this is the first year that returns from casualty and life companies operating as a group may be combined. IRS still has not issued regulations applicable to combined returns, and this is seriously hampering the filing by our companies. Applying the new procedure now would be most unfair, since many of our companies must await the publication of these new IRS regulations.

Accordingly, Mr. Chairman, for the current year we urge that there be no change in the procedure.

Now as to casualty reimbursements. This section would require our member companies to report all payments made during a taxable year of losses which may be subject to casualty loss deductions. Mr. Chairman, we are sympathetic with the objective of the section, but believe that the proposal is both impractical and will increase costs for the insurance-buying public and the Government. We question whether the IRS will be able to cope with the 16 plus million entries provided by property and casualty insurers. Many of the transactions will have involved taxpayers who did not file form 1040 and thus cannot claim any casualty loss deduction. Yet to implement the section, IRS will have to match each return with each entry.

Furthermore, as explained in our statement, in certain situations property and casualty insurers will not be able to provide the desired information.

Besides being impractical, the proposal would be costly. The cost to implement the procedures will be passed on to policyholders by insurance carriers. As suggested above, we question whether IRS will be able to implement the proposal in a cost-effective manner.

Our statement suggests a number of practical alternatives to achieve the desired objective. The one we specifically would urge is to require taxpayers to identify the name of their insurance companies and policy numbers or to certify to the lack of insurance coverage whenever a casualty loss deduction is claimed. This would act as a more effective fraud deterrent than what is under consideration.

In conclusion, Mr. Chairman, we urge reconsideration of the changes in procedure involving a modification of interest in the case of carrybacks and the deletion of the requirement that casualty insurers provide information on casualty losses subject to reimbursement under section 205(c)(3) of the Code.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF THE ALLIANCE OF AMERICAN INSURERS

My name is Andre Maisonpierre. I'm the Senior Vice President of the Alliance of American Insurers, a voluntary association of 150 property and casualty insurance companies. Alliance members provide property and casualty insurance coverages in all 50 states and the District of Columbia. Mr. Chairman, we appreciate the opportunity to testify on the pending legislation aimed to improve taxpayer compliance with the existing tax code.

Our testimony will address two issues. The first deals with the proposed changes to be made in the interest payments due on refunds caused by carrybacks. This issue is covered by section 502(c) in H.R. 6300 and section 113 (c) and (d) in H.R. 5829.

The other proposed amendment which we will discuss in this statement deals with Casulty Reimbursements and is covered by section 205 of H.R. 6300.

MODIFICATION OF INTEREST PAYMENTS IN THE CASE OF CARRYBACKS

Presently the interest which the government pays on carrybacks begins to run from the first day of the taxable year involved. Both H.R. 6300 and H.R. 5829 would modify the procedure. H.R. 6300 would, in future years, delay the government's obligation to pay interest until the last day prescribed for filing the return for the taxable year, as determined with regard to extensions. With respect to the current year, H.R. 6300 would allow interest to be paid until the date of enactment of the legislation.

H.R. 5829 treats the modification somewhat differently. In future years it would ban payment of interest until such time as the taxpayer has filed application under section 6411 or a claim for credit or refund has been filed with respect to such over payment. However, as respect to the filing for taxable year 1981, H.R. 5829 would allow the interest accrued to March 11, 1982 to be paid but would suspend any further payment of interest until such time as the taxpayer has filed his return.

First, a general comment on the concept of the amendment.

We believe the existing procedure is fair to both government and taxpayers. The payment of interest from the beginning of the taxable year prevents unfair enrichment by government. In no way does the present procedure penalize anyone.

On the other hand, postponing the government's interest obligation until either the date of filing of the return or the latest possible due date for such filing penalizes taxpayers and provides for unjust enrichment of government.

It is not reasonable to expect that a taxpayer will be able to file his application under section 6411 or an application for a claim for credit of refund on the first day of the year for the preceding year. A taxpayer must have some reasonable opportunity to "close his books." Any delay in filing acts as a penalty.

From an insurance standpoint, the penalty is even greater since the Code makes it almost impossible for an insurance taxpayer to file early in the year. The Internal Revenue Code requires that property and casualty insurers develop their federal tax returns from data which are taken off the companies Annual Statements filed with the respective state insurance regulators. The Annual Statements must be filed under state law by March 1.

Historically, all of the companies' accounting resources have been directed during the first quarter of the year to the preparation of these Annual Statements.

Thus, property and casualty insurers must first complete their Annual Statements before they can begin to develop their filings for IRS. Completion of the Annual Statements must await the reporting of all transactions completed through December 31 of the taxable year. Even under the best of circumstances, delays must be anticipated.

Our members believe that the present law is fair to both government and taxpayers. It should not be tampered with. However, if Congress is of the mood to limit the interest payments on carrybacks, it is suggested that for future years—beginning in 1983—the law be amended to provide that interest shall be payable under section 6611(f) upon an application filed under section 6411 or when a claim for refund is filed with the government or on the due date for the taxable year, whichever comes first. This would combine the proposals being advanced by H.R. 6300 and H.R. 5829.

Specifically, we would suggest that section 502(c)(1)(A) of H.R. 6300 be amended to read as follows:

"Paragraph (1) of section 6611(f) (relating to refund of income tax caused by carryback or adjustment for unused deductions) is amended by striking out 'prior to the close of the taxable year' and inserting in lieu thereof 'before an application under section 6411 or a claim for credit or refund is filed with respect to such overpayment or the due date for the taxable year whichever comes first'."

With respect to taxable year 1981 there should be no change in the law. This is the first year that returns from casualty and life companies operating as a group may be combined. IRS still has not issued regulations applicable to combined returns. Thus applying the new procedure now will be most unfair to our companies, since many of them must await the publication of the new regulations.

Accordingly, Mr. Chairman, for the current year we suggest no change in the procedure.

CASUALTY REIMBURSEMENTS—SECTION 205

This section would require our member companies to report payments made during the taxable year to a policyholder under "first party" coverage or to a third party when the payment arises out of a negligent action of one of our policyholders if that payment was made to cover a casualty loss which could be deducted by the payee, were there no insurance available.

Mr. Chairman, we are sympathetic with the objective of section 205 but, we believe that the proposed procedure is not only impractical but will increase cost for our member companies—costs which will be passed on to the buyers of insurance.

With respect to the practicality of the section, we question whether the IRS will be able to cope with the millions of entries provided by property and casualty insurers. We estimate that upwards of 16 million transactions will need to be reported. Many of the transactions will have been made to taxpayers who do not file form 1040 and thus cannot claim any casualty reimbursements. There is no way for our companies to know which of the payees are or are likely to use form 1040.

We would expect that the bulk of information provided to IRS will be totally immaterial to the Service. Yet, to implement the section, the Service will have to match each return with each entry.

Furthermore, in third party situations, property and casualty insurers may not be in a position to provide the Service with an accurate figure of payment made to cover a loss subject to casualty reimbursement.

Take for instance a taxpayer who has been injured negligently by another party while driving his automobile. The taxpayer is very severely injured. The automobile is totally destroyed. The negligent party carried low limits on his automobile insurance policy.

It is likely that the insurance carrier will pay the taxpayer the full amount of the policy although, had there been higher insurance coverage a more generous payment would have been made. In this instance, there is no possibility for the insurance carrier to know what part of the payment made to the taxpayer is to be allocated as reimbursement for loss of wages, pain and suffering and medical expenses (none of which are covered under casualty reimbursements) and what to allocate for the loss of the automobile—a covered item under casualty reimbursement.

Another example.

It is quite frequent for casualty insurers to settle third party claims for less than their value if the case involves questionable liability or negligence. Again, which portion of the reduced settlement should be credited to items subject to casualty reimbursements would be anybody's guess.

Besides being impractical, the proposal will be costly. Property and casualty insurers will need to establish new systems to notify the Service as well as the taxpayers. These costs will be passed on to policyholders.

Also to be considered is the extra cost involved to the Service in attempting to cross reference the millions of pieces of separate information provided by insurers with returns filed by taxpayers. We question whether the Service will be able to implement the proposal in a cost effective manner.

There are of course, other ways to get at the objective being sought by section 205. Although we are not urging Congress to do so, consideration could be given to abolishing the casualty reimbursement altogether—or at least abolishing it with respect to losses which generally could have been protected through insurance. The present system is unfair to taxpayers that purchase insurance. They cannot deduct the cost of their insurance premium payments which are in lieu of payments of losses.

Another suggestion would be to increase the deductible to $250 or even more. The present $100 exemption has been in the law for many years. It no longer represents the value of a loss which it did when first introduced in the Code.

We are not urging the Committee to adopt either of these alternatives. They are in the nature of tax amendments. We recognize that this legislation is directed at improving procedure and compliance.

We would, however, urge this Committee to consider requiring a taxpayer to provide information as to why the loss he claims was not covered by an insurance policy. A taxpayer could be required to provide the name of the insurance carrier covering his home, if the loss claimed was on a home or his automobile if the loss applied to a motor vehicle. Insurance policy numbers should also be requested.

If the taxpayer denies having insurance on a property for which he is also claiming an interest deduction, the Service would be alerted to potential fraud since most lenders require insurance on property loans.

We believe that to the extent that there is fraud in claiming casualty reimbursement for losses which have been covered by insurance, requiring a taxpayer to identify the name of his insurance company, and the policy number could act as an effective deterrent. Certainly it would be a more effective tool than what is presently being proposed by section 205 of the Act.

In conclusion, Mr. Chairman, we urge reconsideration of the changes in procedure involving a modification of interest in the case of carrybacks and the deletion of the requirement that casualty insurers provide information on casualty losses subject to reimbursement under section 165(c)(3) of the Code.

Mr. GUARINI. Thank you, sir. Mr. Karl Velde of the Public Securities Association.

STATEMENT OF KARL H. VELDE, JR., CHAIRMAN, MUNICIPAL SECURITIES DIVISION, PUBLIC SECURITIES ASSOCIATION

Mr. VELDE. Mr. Guarini, my name is Karl Velde. I am manager of the municipal bond department of William Blair & Co. in Chicago, and serve as chairman of the Municipal Securities Division of the Public Securities Association.

PSA is a national association of banks, dealers, and brokers that underwrite, trade, and sell State and local government securities and U.S. Government and Federal agency securities. I will address the two provisions of H.R. 6300 which most directly affect the municipal and U.S. Government securities markets—the new registration requirements of section 102 and the expanded information reporting requirements for broker-dealers and dealer banks appearing in sections 201 and 202.

The municipal and government bond markets are among the largest fix income security markets in the world. At present, they collectively account for about $1.4 trillion in outstanding securities. As of the end of 1981, there was over $1 trillion of privately-held Federal debt and $356 billion in municipal debt outstanding.

These markets operate as over-the-counter markets where dealers and investors buy and sell securities by telephone. Due to the size and liquidity of these markets, transaction costs for investors are relatively low. However, should operational burdens be imposed which pose delays in market activity, transactions costs would increase dramatically.

H.R. 6300 would require that all Treasury obligations and State and local tax exempt bonds issued after December 31, 1982, be issued in registered form. The technical memorandum for the bill states that book entry systems of registration will satisfy this requirement. Assuming this to be the case, registration of Treasury obligations would not be expected to cause significant operational problems since over 90 percent of such debt is already on the book entry system.

Municipal securities, on the other hand, generally continue to be issued in bearer form. Registration would represent a significant alternation to the manner in which municipal securities have traded for over a century.

PSA has opposed the imposition of Federal registration requirements for municipal securities. We have stated that the adoption of such a requirement would fundamentally alter the structure of the market, increase borrowing costs for State and local governments, and compromise principles of federalism.

At present, the municipal market consists of 40,000 issuers and approximately 1.3 million outstanding issues. Over the past 10 years, about 44 percent of all municipal bond issues have been for $1 million or less and 81 percent have been for $5 million or less. PSA believes that operational difficulties presented by the registration of municipal bonds would adversely affect this market, particularly for smaller issuers.

While we believe that eventually market efficiencies will compel issuers to issue increased amounts of registered municipal securities, the marketplace, not the Federal Government, should decide whether municipal securities should be issued in registered form.

Both H.R. 6300 and H.R. 5829 impose significant new information reporting requirements. Currently, brokers and dealers in the municipal and government securities markets are not subject to any IRS information reporting requirements. While it may be possible for dealers to report the gross proceeds of transactions, it would be onerous to require them to report investor profit and loss.

Compliance with any new reporting requirements will be particularly costly for smaller regional dealers and dealer banks. Since both proposals provide that the mechanics of these reporting requirements will be prescribed by Treasury regulations, it is impossible to measure precisely the costs of these changes for all types of securities dealers.

We believe that the parameters of any new information reporting requirements and the investors to which they would apply should be expressly provided for in the legislation and not left to administrative interpretation.

Should these information reporting requirements result in the slowing of trading activity it would have direct consequences on the efficiency of these markets, decreasing market liquidity and increasing transactional costs. Any loss in the efficiency of our markets would increase the cost to the Treasury and to State and local governments of financing their debt.

We urge the committee to move with deliberation in considering the appropriate scope of this legislation. You could be altering the fundamental operations of two of the largest sectors of our domestic capital markets. We support reasonable efforts to increase taxpayer compliance. However, we believe that the provisions of these bills, particularly regarding information reporting, are unsupportable without further study of the costs of their implementations.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF KARL H. VELDE, JR., PSA [1]

INTRODUCTION

Mr. Chairman, and members of this distinguished Committee, I appreciate this opportunity to present the views of the Public Securities Association on H.R. 6300, the Tax Compliance Act of 1982, and related legislative proposals. PSA is the national trade association representing banks, dealers and brokers that underwrite, trade and sell state and local government securities and U.S. government and federal agency securities. Our membership accounts for 95 percent of the Nation's underwriting and trading of municipal securities. In addition, 34 of the 35 primary dealers in government securities, as recognized by the Federal Reserve, are PSA members.

PSA supports generally the efforts of both the Administration and the Congress to close the ever-widening "tax gap" by means of improving the ability of the IRS to collect taxes already owed under present law. It is important, however, that in our desire to encourage increased taxpayer compliance we do not adversely affect the efficiency of the public securities markets.

My remarks will address the two provisions of H.R. 6300 which most directly affect the municipal and U.S. government securities markets: the new registration requirements of Section 102 and the expanded information reporting requirements for brokers/dealers and dealer banks appearing in Sections 201 and 202. Similar requirements for information reporting by securities brokers and dealers which appear in H.R. 5829 will also be discussed.

We recognize that efforts to close the present "tax gap" may require the imposition of some new responsibilities upon participants in the fixed income securities markets. We ask that any new responsibilities be prudently and cautiously implemented in the least disruptive and burdensome manner possible. The following brief overview of the markets and the role of the dealers and dealer banks in those markets will be helpful in examining the potential consequences of these legislative proposals.

OVERVIEW OF THE MARKET

The municipal and government bond markets are among the largest fixed income markets in the world. At present, they collectively account for about $1.4 trillion in outstanding securities. As of the end of 1981, there was over $1 trillion of outstanding privately held federal debt, and $356 billion in outstanding municipal debt.

---

[1] Mr. Velde, who is Manager of the Municipal Department and Partner of William Blair & Company, is Chairman of the Municipal Securities Division of the Public Securities Association.

These markets operate as over-the-counter markets, where dealers and investors buy and sell securities by telephone. The importance of these markets may not only be measured by their size, but also by their social utility; the broad access they provide all levels of government to raise funds in the public capital markets at reasonable rates in a quick and orderly fashion.

In the government securities market, the Treasury issued new debt totaling $72.9 billion in 1980 and $87.4 billion in 1981. In addition to new issues, portions of the outstanding debt are refinanced by the Treasury each year. Average daily transactions amounted to approximately $25 billion in 1981 and present estimates indicate that average daily trading volume is now in the range of about $30 billion. Some of the larger government securities dealers report over 3,000 transactions conducted per day.

In 1981, the new issue market for municipal securities reached $85.2 billion, surpassing 1980's record 12 month volume of $76 billion. It is not unusual for the larger dealers in this market to execute over 2,000 transactions in a single day.

THE ROLE OF THE DEALER

The major function of the municipal and government securities dealer, whether a sole municipal or government firm, a dealer bank or a multi-product broker-dealer, is to create a market for U.S. government and/or state and local government securities. This service is typically performed by a dealer's participation in the distribution of new issues of securities or through its participation in the secondary market as a "market maker." A market maker may be described as a dealer who is known to stand ready to purchase or sell securities of a given issuer offered in the marketplace.

As a buyer of fixed-income securities (either as underwriter in the municipal market, distributor in the government market or as a secondary market maker), the dealer assumes the economic risk inherent in holding a security for which the future selling price is uncertain. The risk lies not so much in the default risk of the securities, but rather is derived from the fluctuations in interest rates and the resulting price variation that may occur while these instruments are maintained in inventory. In addition, interest rate fluctuations are of critical importance to the dealer because, to a large extent, his purchases of securities are financed with borrowed funds.

Dealers generally do not charge a commission for the transactions they perform for their customers. Instead, they attempt to earn a profit by selling securities for a price (ask) in excess of the price they paid (bid) for those same securities. This price difference is known as the "spread."

The relatively narrow spreads which generally prevail between the bid and ask price on municipal and government securities is one indication of overall market efficiency. More specifically, narrowness in the bid/ask spreads generally indicates an active, liquid market which is operating with a high degree of transactional efficiency.

For example, on May 12, 1982, the bid price for Treasury bills maturing on August 12, 1982 was 12.40 when the ask price was 12.32. On the same day, December 1982 notes with an interest rate of 9⅜ percent were bid at 97.18 when the asking price was 97.22 and bonds maturing February 1995 with an interest rate of 10½ percent were bid at 82.24 when the asking price was 83.

Examining spreads in the municipal market on prices quoted on May 12, 1982, we see the 4¾ Illinois Toll Road Bonds maturing in 1998 were bid at 53 when the asking price was 51. On the same day, 5.7 percent New Jersey Turnpike Authority Bonds maturing in 2013 were bid at 61½ when the asking price was 63½.

Spreads may increase dramatically, however, should operational and administrative burdens be imposed which cause delays in market activity. We wish to caution the Congress that the amendments to the Tax Code currently being debated may bring about changes to market systems which have worked remarkably well over the years, systems which have distributed enormous volumes of securities with extraordinary efficiency. We advise against taking any steps which may create a less liquid and more volatile market.

REGISTRATION OF MUNICIPAL AND U.S. GOVERNMENT SECURITIES

H.R. 6300 would require that all Treasury obligations and all state and local tax-exempt bonds, issued after December 31, 1982, be issued in registered form. This legislation also contains a provision which would require the reporting of interest income on non-registered municipal securities. It is stated in the technical memorandum accompanying this bill that book entry systems of registration will satisfy this requirement. Assuming this to be the case, registration of Treasury obligations would not be expected to cause significant administrative or operational problems. Present estimates indicate that the book entry system accounts for over 90 percent of Treasury's marketable debt. In addition, the majority of outstanding debt issued by federal and federally-sponsored agencies is in book entry form.

Municipal securities, on the other hand, continue generally to be issued in bearer form. Registration would represent a significant alteration to the manner in which municipal securities have traded for over a century. We urge this Committee, therefore, to thoughtfully and thoroughly examine any prescriptions in this area since a change of this magnitude may result in the disruption of the efficient operation of municipal securities market activity.

PSA has traditionally opposed the imposition of federal registration requirements for municipal securities. We have stated that the adoption of such a requirement would fundamentally alter the structure of the market, increase borrowing costs for state and local governments and, even more importantly, compromise our Federalist system of government. Closer examination of the effects of the recently enacted mortgage revenue bond registration requirements, however, has revealed that the market has adapted unexpectedly well to this change. It is our hope that this preliminary reaction will continue and that the market will learn quickly from this limited experience.

However, we are concerned with the current capacity of automated systems to process, clear and store municipal securities. At present, automated systems of municipal securities clearance and comparison are in the trial stage and not available to all market participants. Depositories for municipal securities are also in the planning stage and their establishment and effective operation is expected to be some time away.

We are also concerned that this registration requirement will prove burdensome on many state and local governments which, according to state law, require that the transfer of registered securities be affected by state or local government officials. In our opinion, increasing the capability of government transfer agents to process a greatly increased volume of securities would be difficult.

Two significant problems which are slowing the process towards a fully automated environment are the large number of municipal issues and the relatively small size of many of these issues. At present, the municipal market consists of 40,000 issuers and approximately 1.3 million outstanding issues. Over the past ten years, about 44 percent of all municipal bond issues have been for $1 million or less and 81 percent have been for $5 million or less. In contrast, the corporate bond market is composed of less than 100,000 outstanding issues.

While the industry is working towards the goal of an immobilized environment for at least the larger and more actively traded municipal issues, we believe that much work to achieve that end needs to be done. In this regard, we believe that a requirement that all municipal securities be issued in registered form is premature; and, from an operational perspective, not cost efficient at this time.

PSA believes that the operational and logistic difficulties discussed above can be resolved within a period of several years. At that time we believe market efficiencies will compel issuers to issue increased amounts of muncipal securities in registered form. However, we believe that the marketplace, and not the federal government, should decide whether and at what point in time municipal securities will be issued in registered form.

INFORMATION REPORTING BY BROKER/DEALERS AND DEALER BANKS

Of great concern to PSA are the provisions contained in both H.R. 6300 and H.R. 5829 requiring significantly expanded information reporting by all brokers and dealers in securities.

Both of these bills would appear to impose broker information reporting requirements for interest payments on government securities as well as broker reporting of transactions involving the purchase and/or sale of government and municipal securities. It is somewhat unclear whether this requirement would also entail broker reporting of gross proceeds of the sale or purchase. It may further require computation of profit and loss, or even perhaps the computation of capital gain or loss. Equally unclear is whether information reporting would be required for transactions executed on behalf of individuals only, or whether all customer related activity would be subject to information reporting.

The technical explanation of H.R. 5829 states that: The bill will direct the Secretary to issue regulations with respect to commodities and securities brokers under the provisions of present law. It is contemplated that the broker will be required to report only information acquired in the course of his business. Thus, if the broker has all information necessary to compute gain and loss, it will be required to include such information. Absent such information, the broker will be required only to report the proceeds of sale. These new regulations will also include reporting on the sale or transfer before maturity of any bond or any corporate evidence of indebtedness in bearer form or any Treasury obligations held by individuals will also be subject to such reporting.

H.R. 6300 further expands these requirements by proposing the addition of a new subsection to section 6045 of the Internal Revenue Code. This amendment would require the submission by the broker or dealer of a statement to each customer setting forth the broker's name and address and such other information as is required to be shown in the information return, filed with IRS, by the broker.

Presently, brokers and dealers in the municipal and government securities markets are not subject to any IRS information reporting requirements. Therefore, the data processing, programming and recordkeeping systems would have to be newly developed. The administrative and operational expenses are likely to be quite significant. We understand that the operational difficulties will be more severe on small regional dealers and dealer banks and somewhat less burdensome for large multi-product dealer firms. Since both legislative proposals, as presently drafted, provide that the mechanics of these reporting requirements will be prescribed by regulations to be later issued by the Secretary of the Treasury, it is impossible to measure precisely the costs of these changes for all types of securities dealers. We believe that the parameters of any new information reporting requirements should, to the extent possible, be included directly in the statutory language, to minimize the uncertainty and confusion which may develop.

The operational problems arising from any statutory or regulatory requirement to compute capital gain or loss would be very substantial. Securities in these markets often have maturities of 20 to 30 years. Therefore, brokers and dealers could be required to retain information on these securities over the entire life of the instrument. Presently, the industry does not have the capacity to accommodate this type of records retention. It is also not unusual for an investor to buy securities from one dealer and sell to another.

Should these information reporting requirments result in slowing of trading activity, it will have direct consequences on the efficiency of these markets by decreasing market liquidity and increasing transactional costs. As discussed earlier, one of the most significant characteristics of each of these markets is their liquidity. We have been able to maintain liquidity by facilities active secondary markets. We have been able to maintain transactional efficiency by serving as low cost conduits distributing municipal and government securities to the public. To the extent that the proposed legislation induces dealers to increase transaction costs or reduce market liquidity, these markets will be made less efficient. Any loss in the efficiency of our markets will increase the cost to the Treasury and state and local governments of financing their debt. We, therefore, caution you to move deliberately in considering the appropriate scope of this legislation. You would be altering the fundamental operations of two of the largest sectors of our domestic capital markets. We hope that Congress will not take any hasty action which will compromise their operational efficiency.

Thank you.

Mr. **Guarini**. Thank you, Mr. Velde.

Mr. Norman M. Epstein of the Securities Industry Association, please proceed.

STATEMENT OF NORMAN M. EPSTEIN, MANAGING DIRECTOR AND EXECUTIVE VICE PRESIDENT, E. F. HUTTON & CO., ON BEHALF OF THE SECURITIES INDUSTRY ASSOCIATION

Mr. **Epstein**. Thank you, Mr. Chairman and members of the committee. My name is Norman Epstein. I am a managing director of E. F. Hutton & Co. I am appearing today on behalf of the Securities Industry Association.

The SIA believes that serious consequences arise from the failure of some taxpayers to report and pay taxes on their transactions, especially in capital assets. Noncompliance fuels the underground economy which we have heard so much about, reduces Federal tax revenues, undermines public confidence in the tax system and destroys support for investment incentives enacted by Congress in the last 3 years.

The securities industry wants to assist efforts to improve compliance and will bear significant costs toward that end. That is why we are participating in these hearings and will meet with the Treasury and IRS officials later this week. The steps needed to improve compliance must be practice, cost-efficient and should achieve their intended purpose.

H.R. 6300 improves on similar bills designed to increase compliance by eliminating some impossible requirements and by broadening applicability to all capital assets. Earlier bills would have required brokers to compute capital gains or losses. Even the largest securities firms currently perform these calculations for less than 1 out of every 100 retail accounts and, I might add, with extreme difficulty.

In many cases, such calculations are not accurate. For example, the asset may have been purchased through a different firm. Multiple purchases of stock in a given company may have been made over a period of years and brokers would not have records of the original price of the stock nor be able to determine exactly which shares were sold. In addition, there are reorganizations, stock splits, name changes, et cetera. Indeed, requiring the calculation of gain or loss could lead those intent on evading taxes to establish multiple accounts with several firms, thereby hiding the cost of the original stock.

Annual reporting of covered transactions or proceeds will alert the Internal Revenue Service to the fact that a taxable event may have occurred. This approach would impose far less cost on securities firms, and would leave the responsibility for determining the basis and date of acquisition with the taxpayer. What I am saying here in no uncertain terms is that visibility will create efficiency.

Estimates that only 56 percent of all capital gains are reported to the Government are distressing. Compliance for securities is over 80 percent, suggesting that massive nonreporting is occurring in other capital assets. Yet earlier bills focused solely on securities and commodities while ignoring other assets, where lower compliance may result in far greater revenue loss. Selective reporting will shift rather than correct willful evasion.

H.R. 6300 increases reporting for all capital assets, including metals, antiques, collectibles, and real estate, as well as securities. For the same reasons, regulations applying to brokers of all assets should be issued simultaneously, rather than beginning with securities and commodities brokers, or with dealers of any single asset type.

While H.R. 6300 is a refinement of earlier bills, some real problems remain. Because many debt obligations have unique interest payment and trading features, expanded interest reporting provisions must be meticulously drafted. We must be careful that registration of all Federal, State and local government obligations not result in higher borrowing costs for those entitles and their taxpayers. Also, previous experience with interest reporting indicates that most large payers will voluntarily use magnetic tape, thereby easing IRS burdens, but mandatory tape reporting may result in prohibitively higher cost for smaller firms.

SIA reiterates its support for increasing the penalties for failure to file information returns or to furnish taxpayer identification numbers. However, the taxpayer's right to appeal should occur after assessment but prior to payment of any penalty, and the burden of proving intentional disregard must reside with the government.

The SIA also supports withholding on interest and dividends when the taxpayer fails to provide a correct tax ID number. However, the penalty would be inappropriate for proceeds of sales. In some cases, the sale may have resulted in a loss or in a gain smaller than the penalty.

Mr. Chairman, the SIA believes that capital transactions should not be used as a vehicle for tax evasion. Some provisions of H.R. 6300 are effective and cost-efficient ways to preclude evasion. Other provisions can be modified to achieve that objective without exorbitant cost. We look forward to working with you on this legislation and we would be happy to answer any questions you may have.

[The prepared statement follows:]

STATEMENT OF THE SECURITIES INDUSTRY ASSOCIATION

Mr. Chairman and members of the committee. The Securities Industry Association appreciates the opportunity to comment on H.R. 6300, the "Tax Compliance Act of 1982."

SIA represents nearly 550 leading investment banking and brokerage firms headquartered throughout the United States which collectively account for approximately 90 percent of the securities transactions conducted in this country. The activities of SIA members include retail brokerage conducted on behalf of 32 million individual shareholders, insititutional brokerage, over-the-counter market making, various exchange floor functions and underwriting and other investment banking activities conducted on behalf of corporations and governmental units at all levels.

SIA applauds and wholeheartedly endorses the basis thrust of the proposed legislation aimed at closing the "tax gap" attributable to non-compliance with the Federal income tax laws, which according to IRS estimates is rapidly approaching the $100 billion mark. As Congress and the Administration seek to narrow triple-digit budget deficits in the next several fiscal years, it behooves the government to give top priority to the pursuit of taxpayers who do not pay their fair share of the tax burden. Our self-assessment system cannot exist without voluntary compliance by all taxpayers. Substantial noncompliance destroys the fabric which holds that system together, namely taxpayers' perception of its fairness and their conviction that everyone else also carries his or her share of the tax burden.

Congress and the Treasury should be assured of the cooperation and assistance of the securities industry in efforts to improve taxpayer compliance. The securities industry is willing to assume reasonable cost in implementing new procedures that will aid in closing the compliance tax gap. Naturally, steps to improve compliance must be operationally feasible, cost efficient, and provide information and procedures that will be useful in increasing taxpayer compliance.

The proposed legislation, in so far as it pertains to the securities industry, contains four relevant elements: (1) expanded interest information reporting; (2) reporting on securities and commodities transactions; (3) standards for mandatory magnetic tape reporting; and (4) revision of the structure of penalties relating to information returns. We would like to offer our comments with respect to each of these elements.

EXPANDED INTEREST INFORMATION REPORTING

The bill would expand information reporting to include interest (including original issue discout) on any debt issued in registered form or of the type offered to the public. In addition, reporting would be required with respect to state and local obligations issued after 12/31/82, unless such obligations were in registered form. In the case of obligations which are not registered or U.S. savings obligations, brokers as the middlemen between the payor and the payee would be required to report interest collected on behalf of the latter.

The proposal evidences an awareness of the difficulties in tracking and reporting interest on bearer obligations by requiring that Treasury obligations, state and local tax-exempt bonds and most private debt obligations issued after 12/31/82 be in registered form. While the magnitude of the compliance problem for bearer issues has not been defined, SIA recognizes this provision as a step towards alleviating any underreporting by holders of bearer securities. However, the costs, procedural problems, and time element involved in requiring registration of these issues are best explained by issuers themselves.

Most of the obligations to be subject to the expanded reporting system are held by government entities (including the Federal Reserve System), banks and other financial institutions, insurance companies, pension funds, and other institutional investors. For example, excluding savings bonds, an estimated $665.2 billion of Treasury issues alone was outstanding in 1980, with little more than 20 percent held by households. Given the large institutional holdings of these obligations and the small portion held by households, imposition of reporting requirements on these instruments would do little, if anything, to close the compliance gap. On the other hand, a reporting system encompassing these holdings would generate a blizzard of information for the IRS, the usefulness of which is questionable.

Many debt obligations have unique and peculiar interest payment and trading features. In order for regulations to be drafted that would be accurate and successfully close any compliance gap, SIA recommends that government staff and industry work closely in designing any expanded reporting requirements. Without active consultation between government and industry, there is a high risk of regulations requiring data that is expensive for the industry to provide and the IRS to process but does little to improve compliance. SIA has already distributed a questionnaire which focuses on current industry record-keeping practices in the dividend and interest area and on the time and cost of possible new reporting requirements. It is clear that any reporting requirements on transactions or proceeds would be most cost effective if done on an annual basis to customers and the IRS.

In view of the need for clarification of the new reporting requirements, the bill sets effective dates of calendar years 1983 and 1984 for these reporting requirements. In this respect, H.R. 6300 is more reasonable than previous proposals as it allows time for government staff and industry to establish a working dialogue on the type of information that is needed and that can be provided on a reasonble basis. Nevertheless, until specifications for the new reporting requirements are defined, the industry cannot accurately gauge lead time and costs involved.

REPORTING ON SECURITIES AND COMMODITIES TRANSACTIONS

H.R. 6300 makes several improvements over earlier proposals in its attempt to close the tax gap on capital gain transactions. Voluntary reporting of capital gain transactions has been estimated at only 56 percent. However, this distressing estimate includes capital gains on real estate transactions, collectibles, depreciable property used in trade or business, and a host of other transactions unrelated to securities or commodities. In fact, it has generally been acknowledged that compliance in capital gains on securities is over 80 percent. Nevertheless, earlier proposals focused solely on security transactions, which represent a very small portion of an estimated $9 billion tax gap. In addition, increasing reporting requirements for some capital assets but not others would shift, not correct, willful evasion. Therefore, we heartily endorse the concept of H.R. 6300 that any increased reporting requirements apply to the full range of capital assets—including metals, antiques, collectibles and real estate, as well as securities.

Earlier proposals would have required brokers to compute capital gains or losses. H.R. 6300 requires reporting of gross proceeds by securities and commodities dealers and may require details regarding profits and losses. For a host of reasons, the reporting of capital gains information by securities brokers on customers' capital gains or losses would impose an enormous record-keeping burden on the industry, the end result of which might yield little usable information to the IRS. Several large firms have reported to us that, at present, capital gain information is reported to 0.01 percent of their retail customers who tend to be their largest and most affluent accounts.

In many cases, capital gain calculation is simply impossible. A security may be bought through one broker and sold through another. Indeed, those individuals intent on evading taxes could establish multiple brokerage accounts with several firms to avoid accurate reporting of gains. Earlier proposals also appeared to approach this problem by requiring the reporting of gross proceeds of sales instead. Although this is a much better approach, it is not without some problems.

The mechanics of reporting of gross proceeds have not been detailed in H.R. 6300. However, while the reporting of proceeds in some format is not the impossible task that the reporting of capital gains or profit and loss information is, there are difficulties and costs involved in this procedure also. Unlike dividend and interest reporting, this is not simply a matter of totalling debits and credits at year-end. SIA hurriedly distributed a questionnaire (attached) to several of its member firms in an attempt to determine the availability of proceeds information and the costs involved in reporting such data. Only a few questionnaires have been returned thus far, but the consensus so far is that any expanded reporting requirements should be presented on an annual basis. To require information each time a transaction occurs would be to ignore cost efficiency for both the IRS and securities firms. SIA urges that government staff work closely witht the industry in drafting regulations for proceeds reporting. A close working relationship would be to the ulitmate benefit of investors and taxpayers, the IRS and securities firms. As additional questionnaires are received and tabulated, the results will be transmitted to your committee before the closing date for written submissions.

STANDARDS FOR MAGNETIC TAPE REPORTING

The bill would authorize the Secretary to prescribe regulations providing standards for determining which information returns must be filed on magnetic tape. SIA recognizes that substantial economies are realized by the Internal Revenue Service when information documents are submitted in magnetic tape form. For many years IRS has promoted magnetic tape reporting by payers on a voluntary basis and its field coordinators have been highly successful in persuading large payers to submit documents in magnetic tape mode. We understand that as a result of these collaborative efforts in calendar year 1978, the most recent period for which data is available, over 89 percent of Forms 1087-DIV (the form most commonly filed by our member firms) were filed on tape. Presumably the percentage is even higher today.

If any standards for mandatory tape filing are to be set, we urge that the Secretary work closely with the securities industry in prescribing such standards. Many small firms lack computer filing capability and would be financially hard-pressed to comply with mandatory tape reporting requirements. Considering that the largest 25 securities firms in terms of capital accounted for almost 75 percent of the gross revenues for the industry in 1981, the volume of business of some firms would be too small to justify the addition of substantial costs and burdens that could be imposed on them. SIA would be willing to assist government staff in analyzing the distribution of business and market share of securities firms in order to determine fair and cost effective standards for mandatory magnetic tape filing.

PENALTIES

We agree with the provisions of the bill to increase from $5 to $50 the penalties for failure to file information returns, and to also increase to $10 or $50, as the case may be, the penalties for failure to furnish taxpayer identifying numbers (TIN), or to include them on the appropriate returns or statements required under the law.

Our endorsement of these stepped up penalties, however, is contingent on the continuation of existing IRS administrative appeals procedures, under which taxpayers seeking to establish reasonable cause enjoy full appeal rights before the Appeals Division, after assessment but prior to payment of the penalty. We urge that the committee's report contain language expressly incorporation this condition.

We have serious reservations about the proposed penalties triggered by "intentional disregard" of the filing requirements. These penalties are intended to parallel those contained in Section 6694 of the Internal Revenue Code relating to tax return preparers. If so, the burden of proof would be upon the taxpayer to establish that he did not "intentionally" disregard the statutory requirements. This burden, coupled with the potential magnitude of the assessments (the failure to file penalty is fixed at not less than 10 percent of the aggregate of the payments required to be properly reported) could well place innocent taxpayers in dire financial jeopardy. We believe that increasing the existing civil penalties under sections 6652 and 6676 as contemplated under the bill, will provide ample incentives to compliance. Superimposing an additional and even more severe set of civil penalties on these increases is unnecessary and, at best, premature. Moreover, criminal provisions of the code are already available to deal with willful and flagrant violations.

If the committee finds it necessary to incorporate the "intentional disregard" sanctions in the legislation, in spite of these considerations, we urge that the statute explicitly mandate that the IRS grant the taxpayer full administrative appeal rights prior to assessment of the penalty. Further, the statute should contain language similar to Section 6694(c), allowing taxpayers to seek judicial review on the basis of partial payment of the penalty assessment.

The Securities Industry Association supports the proposal to withhold a 10 percent tax from interest and dividends credited to a customer's account where the customer failed to supply a TIN or provided an incorrect TIN to the brokerage firm. However, we do not believe that the withholding tax should also be applied to gross proceeds of sales transactions, since such tax would be confiscatory where the transaction resulted in a net loss or in a realized gain amounting to less than the proposed tax to be withheld.

CONCLUSION

The securities industry stands ready to cooperate with the Congress and Treasury in efforts to improve taxpayer compliance. We are willing to assume reasonable costs in closing the compliance gap in capital gains reporting. As SIA testified earlier, most of the non-compliance is in areas outside the securities industry. We strongly endorse the concept incorporated in H.R. 6300 of expanding the reporting requirements to all persons acting as middlemen with respect to all types of property, not only securities and commodities.

H.R. 6300 is also a significant improvement over earlier proposals which would have required the reporting of capital gains, an impossibility for most transactions for nearly all customers. The reporting of customer transactions or proceeds is not without problems, but is a substantial improvement over capital gains reporting, particularly, if done on an annual basis. Before such requirements are implemented, we urge the IRS and Treasury staff to meet with industry experts to discuss what is reasonable and cost effective. SIA has set up just such a task force.

All in all, SIA believes H.R. 6300 is a reasonable proposal aimed at closing the compliance gap. However, until we see all the regulations to be specified by the Secretary of the Treasury, it is impossible to unequivocally endorse the entire bill. We will cooperate fully in developing a reasonable, cost-efficient system that serves the investing and tax-paying public well.

Questionnaire

1. Estimate of transactions* handled for retail customers in 1981

   A. Common Stock and Options # ____________________

   Buy __________% Sell __________%

   B. Corporate Bonds # ____________________

   Buy __________% Sell __________%

   C. Treasury Issues (short- and long-term) # ____________________

   Buy __________% Sell __________%

   D. Other Short-term Money Market Instruments # ____________________

   Buy __________% Sell __________%

   * A transaction is defined by the NYSE as a completed execution. Thus, there may be more than one transaction per order.

2. If your firm were required to report capital gain information annually to the IRS for all retail customers where the basis for the sale was known, what would be the easiest method to present the information. Assume customer name and social security number are to appear on the reporting form. Please describe.

   ____

   ____

   ____

   ____

   ____

   A. Estimate of start-up costs $____________________

   B. Estimate of maintenance costs $____________________

C. Estimate of man-hours involved in start-up ____________

D. Estimate of man-hours involved in maintenance ____________

E. Estimate of earliest tax year for which this system could be operational ____________

F. At present, does your firm report this information to any retail customers. No ___ Yes ___

If YES, in what form. ______________________________

____

What is the % of total retail customer base to which this information is reported? ________%

3. If your firm were required to report gross proceeds of sale information annually to the IRS for all retail customers, what would be the easiest method to present the information. Assume customer name and social security number are to appear on the reporting form. Please describe. ______________________________

____

____

____

____

A. Estimate of start-up costs $____________

B. Estimate of maintenance costs $____________

C. Estimate of man-hours involved in start-up ____________

D. Estimate of man-hours involved in maintenance ____________

E. Estimate of earliest tax year for which this system could be operational ____________

F. At present, does your firm report this information to any retail customers on an annual basis. No ____ Yes ____

If YES, in what form. ______________________________

____

What is the % of total retail customer base to which this information is reported? ________%

4. Are there special problems related to certain securities, such as bearer securities, in reporting capital gain or gross proceeds of sale information. Please elaborate. ______________________________

____

____

____

____

5. At present, does your firm report to the IRS via magnetic tape.

Yes ____ If yes, at what cost. $______________

No ____ If no, what would be the cost of implementing this type of reporting. $______________

Are there any special problems you foresee in doing so. Please elaborate. ______________________________

____

____

____

____

6. Please elaborate the special problems related to reporting discount on original issue interest. ______

______

______

______

______

7. Please elaborate the special problems related to reporting interest on bearer obligations. ______

______

______

______

______

8. Estimate of time and cost to implement expanded interest reporting requirements.

   A. Estimate of start-up costs .. $______

   B. Estimate of maintenance costs $______

   C. Estimate of man-hours involved in start-up ______

   D. Estimate of man-hours involved in maintenance ______

Submitted by: ______
Name

______
Firm

______
Number of retail accounts

Mr. GUARINI. Thank you, Mr. Epstein.

Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman. Mr. Barber, how would you describe the people engaged in direct selling? Are they wealthy people?

Mr. BARBER. I believe I will let Mr. Offen answer that.

Mr. OFFEN. Eighty percent of our well over 4 million salespeople are women, 15 percent are minority group members, 10 percent are senior citizens over the age of 65, and another 10 percent or so are people who have a physical disability, usually a temporary one.

According to Lou Harris, 8 percent of the homes in this country have someone who during the course of a year sells for one of our companies or will in 1982, and an additional 15 percent of the homes have someone who in the past has sold. So we have almost a quarter of the population of all households being represented in all households. So it is really a middle-America industry.

It is the average citizen who is involved in our industry, primarily women.

Mr. DUNCAN. How many people are engaged in supplemental sources of income?

Mr. OFFEN. Well over two-thirds of the people are classified as part-timers. They are all, of course, independent contractors and they do work less than 30 hours a week. As a matter of fact, in our latest research, as much as 90 percent of our sales people work part time.

Mr. DUNCAN. What efforts, if any, do your member companies make to encourage compliance with the IRS laws?

Mr. BARBER. Our major contact with these people, of course, is through newsletters and mail and many companies send reminders around tax time to remind them of their tax obligations and then the manuals or guides that they supply to them have detailed instructions on how to figure their taxes.

In the case of our own company, we send to all of our sales people a coupon which they may take to a tax preparing organization, a national one, which is Beneficial Finance, and they can take this coupon to their office and have their tax returns figured at a discounted rate.

Mr. DUNCAN. At the end of the year do you give them a statement showing them how much they have earned?

Mr. BARBER. I am sorry?

Mr. DUNCAN. At the end of the tax year, do you give your employees a statement showing their sales and earnings and so forth?

Mr. BARBER. That is very difficult to do because you have some people come in maybe at the first quarter and then they drop off your rolls and they come back in at the fourth quarter and your computer storage capacity in the larger companies cannot even handle all of that. So we are not able to aggregate that down to the end of the year.

Some companies do provide the aggregate amount.

Mr. OFFEN. Compensation would be reported under the present law on 1099 compensation forms, but over 90 percent of the sales people in the industry are in a buy-sell relationship and do not receive compensation from the companies with whom they are associated. But the 1099 $600 present law figure is met by all the companies.

Mr. DUNCAN. They do get the 1099?

Mr. OFFEN. They certainly do.

Mr. DUNCAN. Thank you very much, gentlemen. This has been a good panel.

Mr. GUARINI. Mr. Moore?

Mr. MOORE. Thank you, Mr. Chairman. Mr. Epstein, I assume that E. F. Hutton, the company for which you work, and other industries in the trade association which you represent are now selling individual retirement accounts. Is that correct?

Mr. EPSTEIN. Yes, sir.

Mr. MOORE. Earlier in the day Assistant Secretary Chapoton testified that section 311 of H.R. 6300, which would increase the penalty for early withdrawal from an IRA from 10 percent to 15 percent, could well impede the sale of IRA's to low- and middle-income groups. Do you have an opinion on that comment by Secretary Chapoton?

Mr. EPSTEIN. I disagree.

Mr. MOORE. You disagree?

Mr. EPSTEIN. Yes, sir.

Mr. MOORE. Would you care to expand on that answer?

Mr. EPSTEIN. I do not think it would have any effect, unless you are saying the intent is to withdraw.

Mr. MOORE. I do not understand that.

Mr. EPSTEIN. I do not think it would have any effect unless you say the intent is to withdraw.

Mr. MOORE. His testimony was to the effect that many low- and middle-income groups who are being enticed into individual retirement accounts have a limited amount of disposable income to invest or to save. This may well be their first savings account.

His fear was, as I understood his testimony in rereading it here a moment ago, that very often when they are faced with financial crises they may well have to withdraw. If they are facing an increased penalty, they may well never start the individual retirement account to start with by virtue of that high penalty and not being able to afford the penalty. Other investors, however, acquainted with buying stocks and bonds may not be so concerned.

That was his point of view.

Mr. EPSTEIN. Speaking for E. F. Hutton, it would not have an impact.

Mr. MOORE. Can you tell me the people to whom you are currently selling individual retirement accounts, what income groups they largely are falling into?

Mr. EPSTEIN. Basically the established customers of E. F. Hutton, certainly this is a sales tool to bring on new customers. We are talking about the full range of middle America. Basically an IRA, certainly every individual that has an account with E. F. Hutton would be a potential buyer of an IRA and would not fall into the situation that you brought out initially.

Mr. MOORE. Do I understand you to say that your existing customers would not fall into the low- to middle-income groups?

Mr. EPSTEIN. That is what I am saying.

Mr. MOORE. Thank you. No further questions, Mr. Chairman.

Mr. GUARINI. Mr. Epstein, do you think that there should be any kind of report made on sales of antiques and real estate?

Mr. EPSTEIN. Absolutely.

Mr. GUARINI. How would you suggest that be done, if we could use your expertise on that?

Mr. EPSTEIN. The same way you are expecting me to do it in the brokerage house.

Mr. GUARINI. Have attorneys or title companies do it?

Mr. EPSTEIN. Just isolate that constituency which is responsible and nail them.

Mr. GUARINI. It would be very interesting to see how the antique issue works because, as I understand, that is a cash and carry operation pretty much. It is probably the best known way that people hide income in the United States.

But I understand real estate——

Mr. EPSTEIN. Speaking for them, I have never made money on anything.

Mr. GUARINI. Maybe you have not sold what you bought yet.

I would like to ask Mr. Velde, do you feel that although registering bonds would slow down the transactions, do you feel that the Government would end up collecting more money and obtain more revenue if we did have the bonds registered?

Mr. VELDE. That, of course, would depend entirely on the use that the IRS is able to make of the information that they derive from bond registration. I think you would have to address that question to the IRS.

Mr. GUARINI. Well, you know that there are many hundreds of millions of dollars that are involved in bearer bonds.

Mr. VELDE. Yes.

Mr. GUARINI. And many people would seek that vehicle for not having a record made, if possible. Don't you think that by requiring them to register and put it in registered form that the Government would end up receiving more tax collectibles?

Mr. VELDE. I will say this. I think that the Government would receive the information. The actual use that the IRS would be able to put it to, as I say, I think would have to be determined by the IRS.

Mr. GUARINI. The Chair wants to thank each and every one of you gentlemen for your help, your expertise and having taken the trouble to come before us today. Thank you very kindly.

Mr. Lloyd G. Ator of the American Bankers Association, Mr. Alexander Zakupowsky of Deloitte, Haskins & Sells, and Mr. Dwight C. Moorhead, of Petro-Lewis Corp., please come forward and make yourselves comfortable.

Mr. Lloyd Ator of the American Bankers Association, we welcome you and ask you to present your statement.

STATEMENT OF LLOYD G. ATOR, JR., TAX COUNSEL, AMERICAN BANKERS ASSOCIATION

Mr. ATOR. Thank you, Mr. Guarini and members of the committee. I work for the American Bankers Association as their tax counsel. The ABA appreciates the opportunity to testify before you on H.R. 6300 and the related proposals.

The ABA, of course, as you have heard other witnesses testify, fully supports both administrative and legislative efforts to narrow the so-called compliance gap. I guess it is a real compliance gap. We are concerned, however, that several provisions of these bills do little in fact to increase compliance with the Internal Revenue laws while, at the same time, they impose substantial real cost burdens on taxpayers.

As you know, copies of the bill first became available late Wednesday afternoon. We have made those copies available to a number of banks and asked them to go over the provisions with their operations people. I suspect that those reports, when they arrive back—and we will furnish them to the committee—will provide much more telling analysis than the type of analysis that tax lawyers ordinarily provide.

Commercial banks are certainly a logical place to look for opportunities to monitor financial transactions. Our concern is that the goal of increasing the information available to the Government will be pursued without due regard for the cost burden imposed on business and without due regard for the use that the IRS can make of this information.

Banks are financial intermediaries. They, particularly money center banks, process literally thousands of pieces of information daily. I am told that in the money center banks that the piece of paper which is known as a certificate of deposit or a negotiable instrument is almost disappearing. For those banks, most of that exists only in a computer memory. We believe that the cost of these various provisions has to be balanced against the benefits to be derived from them.

My comments here necessarily represent only a rough preliminary analysis of those provisions. We will file a more detailed analysis within the next 10 days. Let me comment on several of the items that, just on that preliminary analysis, strike us as presenting difficulties.

First of all, the registration of tax exempt obligations is intended to limit the use of these obligations as a medium of exchange. The technical explanation talks about their use particularly to disguise nontaxed income and for use in illicit transactions. The provision applies prospectively only.

Our judgment is that there is enough volume of unregistered, tax exempt obligations of different denominations out there to satisfy the needs of those who wish to use them as a medium of exchange for years to come. At the same time, it would be unfair and probably impossible to require retroactive registration.

Another concern is that the registration of these obligations may in fact simply drive many investors into offshore markets and out of the United States. This not only deprives State and local governments of needed capital, it could have an impact on the liquidity of the bond market.

The registration of instruments held by individuals can also result in a segmented market in which there will be a difference in price for the same obligation—one for obligations sold to corporations and the other for those sold to individuals.

With regard to the penalty for underpayment due to fraud, we believe that the provisions of H.R. 6300 represent a substantial improvement over the equivalent provisions of S. 2198 and H.R. 5829. Under those bills, as you are aware, there was concern that corporate directors, officers, employees, and agents could be liable for very substantial civil fraud penalties where they had no knowledge of the statement which resulted in the underpayment.

The provision of H.R. 6300 requiring a third party recordkeeper to assemble all books and records described in an administrative summons, even during challenge, is likely to be needlessly expensive and time consuming without any apparent benefit to the Government. This is particularly true in the case of an overbroad administrative summons of a fishing expedition variety. As a practical matter, these administrative summons are issued by agents every day. Banks as recordkeepers receive an astounding number of them. We find that, in the usual course of things, there is a series of negotiations with the IRS in which the scope of the inquiry is substantially narrowed before the summons must be complied with.

The expanded interest reporting provisions may improve compliance. They will certainly increase the amount of information the IRS has to deal with. However, we would like to have an opportunity to analyze those provisions in terms of their impact on capital markets. This involves explaining the provisions to money market traders and having them give us an analysis.

As far as the provisions dealing with the application of a formal document request to documents related to overseas businesses are concerned, we believe that, as drafted, they are completely unrealistic. They miss the point. They are likely to be ignored by the international drug traffickers and burden legitimate businesses instead. At least the taxpayer should have the same basic legal rights to challenge an overbroad request for information as are available with respect to its domestic books and records. We note particularly the provision that says exposure to foreign civil and criminal prosecution is not reasonable grounds for failure to produce books and records. Is this how we would like other countries to view our privacy laws? In that context, it is hard to imagine what would be a reasonable cause. We think that there are severe constitutional problems with this, and although we are sympathetic with the goals, we think a more precise mechanism, a more moderate approach to the penalty might be much more productive.

Finally, the provisions of H.R. 6300 treating interest on carry-back refunds eliminates the objectionable retroactivity of S. 2198 and H.R. 5829. We feel, however, that this problem is created by the present, unrealistically high, 20 percent interest rate on overpayments, and that more frequent adjustment of the interest rates will cure the problem. We also feel it is just a question of basic equity. If the Code provides for a carry-back refund, technically that refund is due from the close of the last day of the taxable year in which it arises.

We look forward to working with the committee staff in refining these provisions. As I have said, we support completely the notion of improving taxpayer compliance. It would be unfortunate if the committee rushed into this without actually doing some kind of cost benefit analysis of the effects of this act.

[The prepared statements follow:]

STATEMENT OF LLOYD G. ATOR, JR.

SUMMARY

The American Bankers Association fully supports legislative and administrative efforts to improve taxpayer compliance with the internal revenue laws. A number of the provisions of H.R. 6300 would not only fail to improve such compliance, but would have an adverse effect on conscientious taxpayers, legitimate business arrangements, financial markets, and financial intermediaries, including commercial banks.

Although individuals with operating responsibility for the different areas of bank operations affected by various provisions of H.R. 6300 have not had an opportunity to analyze the bill and its impact on their particular areas of operation with the care and thoroughness such proposals deserve, there are a number of problem areas apparent from a first reading of the bill to the existence of which the ABA would like to alert the Committee. The ABA will provide a more detailed statement of analysis and commentary in the near future, but felt it necessary to inform the Committee as early as possible on those concerns already apparent.

The ABA looks forward to working with the Committee to improve H.R. 6300 so that it will accomplish its intended purpose without imposing unnecessary or counterproductive administrative and compliance burdens on taxpayers affected by its provisions.

STATEMENT

Mr. Chairman, Members of the Committee, I am Lloyd Ator. I work for the American Bankers Association as their tax counsel. The ABA is the national trade association for commercial banks. There are more than 14,500 commercial banks in the United States, and more than 90 percent of them are members of the ABA, including more small banks than any other trade association.

The ABA fully supports the purposes for which H.R. 6300 was introduced. We agree with you, Mr. Chairman, that it is patently unfair to the large number of conscientious taxpayers in this country who comply with the tax laws to the best of their ability not to do what we can to make sure that those who willfully avoid complying with the internal revenue laws are compelled to pay their fair share of the tax burden. We are concerned that H.R. 6300 will have unintended adverse consequences for taxpayers, legitimate business arrangements, and financial intermediaries such as commercial banks. These unintended consequences range from the potential imposition of cost burdens on financial intermediaries that exceed the revenue or compliance benefit to be derived from their imposition to the possible infringement of certain basic principles of our income tax system and of basic rights of taxpayers as citizens and residents of the United States.

As you know, copies of H.R. 6300 became available last Wednesday afternoon. Although copies were promptly made and distributed to members of the ABA Taxation Committee, yesterday was the first day members of that committee had an opportunity to confer with the operations personnel in the various operational divisions of their banks about the impact of H.R. 6300 on bank operations. Based on a limited telephone survey of those banks yesterday afternoon, the following comments reflect first impressions and limited analysis. Such serious and important proposals deserve more careful analysis. We hope to provide a more detailed analysis and commentary to the Committee within the near future. Accordingly, my statement today will touch only on those issues most readily apparent to those who had an opportunity to review the draft over the weekend and discuss it with operations personnel yesterday.

Registration of tax-exempt obligations

Under section 102 of the bill, the issuance of bearer obligations to the public in the future would be discouraged, according to the Joint Tax Committee Staff's Technical Explanation, by denying tax-exempt status to unregistered obligations. According to the Technical Explanation, this is necessary because unregistered obligations are used in commercial transactions as substitutes for cash and they may be used to conceal untaxed income or as a medium of exchange in illegal activities.

First, the bill seems to recognize that it would be unfair, and probably impossible to require the registration of outstanding tax-exempt obligations. It would appear that there are likely to be a sufficiently large and diverse number of such pre-1983 obligations available in the marketplace to frustrate those policy goals for many years to come.

Second, by imposing a registration requirement, the bill simply increases to some degree the administrative and issuing costs to state and local governments. That does not seem to be a desirable policy result.

Third, by providing for the registration of these obligations, some investors will be driven into the offshore market. This will reduce the amount of funds available to the state and local bond market, reducing liquidity in that market, depressing prices and increasing yields. Although section 102(d)(2) of the bill overrides existing United States tax treaties to the extent that new issues of foreign obligations that are "registration-required obligations", it is unlikely that this will have a serious impact on the availability of investment vehicles.

Penalty for underpayment due to fraud

The proposed amendment of section 6653 of the Code by section 121 of H.R. 6300 to increase the penalty for underpayments due to fraud is preferable to the equivalent provisions of S. 2198 and H.R. 5928. Under those measures, there was concern that a corporate director, officer, employee, or agent who had no knowledge of a fraudulent statement which resulted in an underpayment would be exposed to substantial civil fraud liability.

Duty of third-party recordkeeper

Section 132 of the bill amends the Internal Revenue Code to require a third party recordkeeper, such as a commercial bank, to proceed to assemble records requested under an administrative summons and to be prepared to produce them on the date set for their examination by the summons, even when the summons is being challenged. The production and compilation of requested records is time-consuming, expensive, and potentially disruptive of normal business record processing. Administrative summons are challenged daily across the country and subsequently withdrawn or modified significantly. This is particularly true when the administrative summons is overbroad and amounts, more or less, to a fishing expedition. Why should these potentially expensive burdens be imposed on third party recordkeepers simply to save the government time in proceeding to an examination of books and records where there is no challenge or the challenge is completely unsuccessful?

Expanded interest reporting

Like many provisions of H.R. 6300, the expanded interest reporting provisions under the amendments made by section 201 of the bill are not entirely clear in their application. It is clear that they could impose substantial operational costs.

By way of illustration, consider the application of these provisions to what is known as a coupon bond. Here's how one works. A bondholder takes his bond coupons to his local bank, where they are accepted for collection in the same manner as a check drawn on another bank would be accepted for collection. The bondholder's account then is conditionally credited with the interest payable on the bond represented by the coupon. As with a check drawn on another bank, the deposit is accepted subject to collection.

The bank then places all coupons received in a special envelope called a shell, and forwards it to that bank's correspondant bank. The correspondant bank, in turn, forwards the shell to the paying agent bank or to another correspondant bank in the collection chain.

When the paying agent bank receives the shell, payment is made back through the collection chain unless the bond has been called at an earlier time, there is a stop-payment order on the bond, or there is an error in the entries on the shell as to the issuer, the number of coupons, the amount due, or other information.

The payment of these interest coupons is handled by the bondholder's local bank just as it would handle a deposited check, with no additional customer deposit records made. Reporting on the interest paid would require the bank to establish a new customer account record just to report the interest. Customers frequently own several different issues on which the coupons become due twice a year. The burden of keeping track of these and reporting the interest payment falls on the bank, even though it is acting merely as the initial collecting agent.

Withholding at source

Under the bill, payors of interest and dividends will be required to withhold tax at a rate of 10 percent where the recipient fails to furnish his taxpayer identification number or where the Internal Revenue Service has notified the payor that it has furnished an incorrect TIN. Many of the objections voiced by payors of interest and dividends to generalized withholding apply with equal force to this proposal. Compliance in this area is already high—in the 85 to 90 percent range according to the Treasury—and the cost to institutions such as commercial banks to comply with the reporting and withholding requirement may exceed the benefit to be gained from the proposal. We would like to look at this proposal more carefully.

In this connection, it may be helpful to point out that any operation requiring hand processing increases operating expenses for a bank dramatically. Many of the transactions affected by this provision are sporadic across-the-counter transactions. Anyone who has waited impatiently in line for a teller will verify that having to wait while a form is filled out is extremely frustrating. For 1981, the First and Merchants National Bank in Richmond, Virginia, with 114 branches processed 500,000 Series E Savings Bonds, an average of approximately 2,000 per working day. While it is unlikely that these bonds were redeemed one at a time, you can easily see how even a provision of such apparently limited scope and constructive purpose can lead to an expensive administrative problem for financial institutions across the country.

In addition, IRS notifications of incorrect taxpayer identification numbers are often incorrect themselves. Where withholding has been instituted as a result of such a wrongful notification, how is the taxpayer to be compensated for the amount wrongfully withheld?

Transactions outside the United States

Generally speaking, the provisions of title IV appear to represent an unrealistic overreaction to a limited number of problems centering around drug trafficking and other illegal activities and the use of tax havens. It is unlikely that these provisions will have a serious effect on illicit activities, other than forcing a rearrangement of the laundering and investment practices for funds generated by these nefarious activities. These provisions, however, will have far reaching and serious consequences for legitimate international business operations, they could result easily in double taxation or the taxation or gross receipts, and they could expose citizens of the United States to civil and criminal liability abroad if they comply with these provisions.

Specifically, a taxpayer upon whom an administrative summons is served under present law has the right to have the reasonableness of the request determined judicially before he is compelled to comply with the request. Under section 131 of the bill, a special procedure is even provided under which a taxpayer can challenge an administrative summons in court. As noted earlier, administrative summons are regularly and successfully challenged daily, resulting usually in a narrower scope of inquiry and a narrower intrusion by the government into the lives of its citizens.

Under section 982 of the Code, as proposed by the bill, a taxpayer who "fails to substantially comply" with a formal document request in connection with documents maintained in a foreign country is foreclosed from having the reasonableness of the inquiry determined by a court until it is too late to comply. A taxpayer presented with a formal document request which would be quashed as overbroad if challenged, is exposed to the risk that his failure to comply will not—in subsequent litigation—be found to be due to reasonable cause. The proposed statute says that exposure to foreign civil or criminal prosecution is not reasonable cause. What, then, would be reasonable cause?

No distinction is attempted here between receipts from illicit activities and receipts from legitimate business enterprises; nor between tax havens and other jurisdictions. The penalty for guessing wrong that the request was overbroad is simply a tax on gross receipts, with no offset for foreign taxes paid. The Sixteenth Amendment empowers the Congress to impose taxes on income. Does this provision go beyond the authority provided by the Constitution? To the extent that it would result in a tax on gross receipts, it would appear to do so.

Surely the problems sought to be addressed by this somewhat Draconian approach could be reached better through a more limited, more precise mechanism.

Banks and other financial institutions in the United States are liable for damages to customers for wrongful disclosure of information protected by our bank secrecy laws, which we call privacy laws. It would appear to be most awkward for the United States to insist on a double standard in this regard by subjecting its own citizens to the risk of foreign civil or criminal prosecution for complying with this new requriement.

Finally, if a commercial bank refused to comply with such a formal document request due to laws applicable to one of its foreign branches, the bill permits the Secretary of the Treasury to require the bank to maintain "documentation with respect to that trade or business" in the United States at a place designated by the Secretary. It is difficult to guess what documentation might be required under this provision, but it is quite possible that compliance with such a requirement with respect to foreign branch operations would also violate the laws of the host country, be extremely expensive, and serve no useful purpose, since the documentation would appanently remain subject to formal document request rather than the domestic administrative summons procedure.

Restrictions on payment of interest on certain refunds

The provisions of section 502 of H.R. 6300 are preferable to the equivalent provisions of S. 2198 and H.R. 5829. Under current law, a refund arising out of a net operating loss carryback, net capital loss carryback, or credit carryback is treated as having occurred at the close of the year in which the carryback arose. Under the bill, the overpayment would be treated as occurring on the due date for the return, including any extensions of that due date, for the year in which the carryback arose. One problem created by these changes for commercial banks is that banks with substantial foreign lending are unable to obtain necessary tax return information and documentation for foreign tax credits until June or July. These provisions would deprive such banks of interest on underpayments resulting from the closed taxable year's operations. Put another way, the overpayment is actually determined as of the close of the taxable year in which the carryback arose and technically exists as a claim against the government from the last day of that taxable year.

These preliminary and somewhat cursory observations will be supplemented with more specific comments as soon as more detailed analysis is available from ABA member banks. The failure to comment on any aspect of H.R. 6300, S. 2198, or H.R. 5928 should not be taken to mean that the ABA endorses or accepts any particular provision or concept expressed there.

The American Bankers Association thanks you for the opportunity to present this preliminary evaluation and looks forward to working with you and your staff to develop reasonable means of improving taxpayer compliance with the internal revenue laws.

STATEMENT OF THE AMERICAN BANKERS ASSOCIATION

The American Bankers Association would like to thank the Committee for this opportunity to submit additional comments on H.R. 6300 and H.R. 5829 both of which deal with taxpayer compliance. The American Bankers Association is the national trade organization for more than 90 percent of the nation's 14,500 commercial banks, including more small banks than any other financial trade association.

RESTRICTIONS ON PAYMENT OF INTEREST ON CERTAIN REFUNDS

Section 502 of H.R. 6300 and section 113 of H.R. 5829 would substantially modify the present law which provides for the payment of interest on a carryback claim starting from the close of the taxable year in which the loss or credit carryback is generated. The proposal would limit the interest paid on refund claims by restricting the accrual of interest until a refund claim is filed. It would apply to payments of interest after enactment date; for 1981 returns, under H.R. 5829 no interest would accrue from March 11, 1982 until the date the refund claim is filed; under H.R. 6300 interest would accrue until the date of enactment, suspended thereafter until the refund claim is filed.

The proposal would place a great administrative burden on taxpayers and their tax advisors. Large corporations, many of which are multi-divisional and multi-national, simply cannot obtain and correctly analyze the large volume of data necessary to file a complete, accurate and processible return much before the September 15 extension date presently permitted for timely compliance. The proposal would place enormous pressure on the filing of a loss year return as soon as possible after year-end. Few companies have sufficient personnel to prepare their tax return in the first quarter of the year; similarly, professional return preparers do not have sufficient personnel to prepare all loss company returns in the first quarter.

The proposal would provide an inequitable result int the case of adjustments on revenue agent examination which result in an increase in tax for one year which is offset by a net operating loss for a subsequent year. Interest would continue to be payable by the taxpayer with respect to the first year under payment from the time the return was due, while interest would no longer be payable by the IRS with respect to a reduction in tax due to the concommitant audit adjustment made for the following year's return. Currently the two adjustments offset as of the first day after the end of the loss year.

This inequity would occur for such audit adjustments which are merely timing differences, including audit adjustments based on court decisions, regulations, and rulings issued some years after the tax return had been filed. Where all the economic events and transactions which generate the tax refunds have occurred and the taxpayer merely needs more time to file a complete and proper return, it would be unjust to make an exception in favor of the IRS.

The object of these provisions appears to be to encourage taxpayers to file their refund claims immediately after the close of the taxable year when, as now, the interest paid on the refund is higher than the market rate. Once an appropriate interest rate is established, the procrastination by some taxpayers in filing carryback claims should disappear. Toward that end, the ABA supports the enactment of a semi-annual determination of the interest rate, such as is provided in section 111 and 112 of H.R. 5829 and section 501 of H.R. 6300.

As alternatives to the provisions of the bills dealing with the suspension of interest paid by the IRS on NOL carryback claims, the ABA proposes the following amendments to provide incentives for taxpayers to file returns and tax refund claims as early as practicale and reduce the interest cost to the IRS: (1) a one percent per month reduction in the prescribed interest rate on tax overpayments beginning June 15 (the end of the first extension period) of the year following the year of the loss carryback. This interest rate reduction would continue until processible return is filed; or (2) interest would be payable from January 1 to September 15 (the end of the second extension period) and thereafter would be suspended until a processible return is filed.

ADMINISTRATIVE SUMMONSES

Under present law, when the Internal Revenue Service serves an administrative summons on a third-party recordkeeper, such as a bank, requiring that person to produce records relating to a taxpayer, notice of the summons must be given to the taxpayer. The taxpayer may stay compliance with the summons by giving written notice to the third-party recordkeeper not to comply with the summons. In that event, to enforce the summons the Internal Revenue Service must then bring a proceeding in federal district court at which time the taxpayer and the third-party recordkeeper may assert any defenses which they may have to the summons.

Section 131 of the H.R. 6300 would shift the burden of initiating the court proceeding to the taxpayer by requiring that he, rather then the Internal Revenue Service, commence a proceeding in federal district court by means of a motion to quash in order to stay compliance with a summons. The motion must be filed within 20 days after notice of the summons is given to the taxpayer and the Internal Revenue Service may not examine records in response to the summons until after 23 days following such notice.

With certain minor modifications, we agree with these proposed changes in the administrative summons area. As mentioned above, the taxpayer may stay compliance with the summons merely by giving a written notification to the third-party recordkeeping not to comply with the summons. Many of our member banks receive a significant volume of notices from taxpayers not to comply with such summonses. It often seems that many taxpayers give such notice simply because it requires very little cost or effort for them to do so, even though they either have no intention initially of contesting the enforcement proceeding or later, upon advice of their attorneys, change their mind about the wisdom of doing so. Generally a relatively long period of time (i.e., up to one year) passes between the time the summons is served and the enforcement proceeding is brought. In the meantime, in order to be in a position ultimately to respond to the summons if the court authorizes it, the third-party recordkeeper generally must gather the records before they become unavailable and maintain them in anticipation of the eventual enforcement proceeding. By placing the burden of initiating the proceeding to quash on the taxpayer, at his expense, it is our opinion that this will tend to discourage those taxpayers who are not genuinely interested in contesting the summons. Third-party recordkeepers (and the United States Attorney's office) would thereby be relieved of a great deal of wasted time and money if taxpayers, records concerning whom are summoned, did not have the ability to stall the investigation simply by sending a written notice to the third-party recordkeeper instructing them not to comply.

Section 7609(i)(1) of the Code would be amended by section 132(a) to provide that the third-party recordkeeper must proceed with assembly of the records as soon as the summons is received in order to have them ready for production on the day on which the records are to be examined. The effective date for such provision is the day after the date of enactment of the Bill. However, the effective date of Section 131 of the Bill, that provision just discussed which shifts the burden of bringing the proceeding to the taxpayer, is to be December 31, 1982. We submit that there is no reason to make Section 132 effective at an earlier date than Section 131. It is not until the implementation of Section 131 that the large volume of notices to third-party recordkeepers not to comply with the summons and the long delays between the time the summons is served and the enforcement proceeding is brought can reasonably be expected to diminish. Therefore, we submit that the effective dates of both Section 131 and Section 132 should be identical.

Section 7609(i)(2) of the Code, as amended by section 132(a) of the Bill, provides that after 23 days have elapsed following notice to the taxpayer, the Secretary may issue a certificate to the third-party recordkeeper that no proceeding to contest the summons has been brought within the time permitted. At that time, if the taxpayer has not initiated a proceeding to quash the summons, the third-party recordkeeper will be compelled to turn over the summoned information to the Internal Revenue Service. Section 7609(i)(3) of the Code would then provide that the third-party recordkeeper will be protected from liability if disclosure of the records is made in good faith reliance upon such certificate. Presumably the intent of such provision is to enhance the cooperation of third-party recordkeepers by eliminating the possibility that they may be liable to any customer or other person for such disclosure.

In order to eliminate any ambiguity, and to insure that these procedures are followed in every case, we believe that the issuance of such certificate by the Secretary should be mandatory rather than optional as that provision, as it is presently worded, might be interpreted. Therefore, we submit that the proposed section 7609(i)(2) of the Code be amended to read as follows:

"(2) Secretary must give recordkeeper certificate. If the period prescribed for beginning a proceeding to quash a summons has expired and no such proceeding was begun within such period, before the third-party recordkeeper shall be required to disclose records pursuant to the summons, the Secretary must issue a certificate to the third-party recordkeeper that the period for beginning a proceeding to quash a summons has expired and that no such proceeding began within such period."

PENALTY FOR SUBSTANTIAL UNDERPAYMENT OF TAX

Section 503 of H.R. 6300 imposes an interest surcharge if a corporation's tax liability is understated on its return by $5,000 or 10 percent of the amount of tax it owes for the year. The surcharge is set at 20 percent of the interest due on the underpayment. Section 125 of H.R. 5829 imposes a penalty of 10 percent of the amount of a corporation's underpayment of tax liability if the underpayment exceeds the greater of $10,000 or 10 percent of the amount required to be shown on the return.

These provisions are apparently designed to discourage the use of abusive tax shelter schemes, a purpose with which the ABA is in full agreement. However, these provisions take a broad-brush approach where a more narrow measure would be more appropriate. H.R. 5829 with its mandatory penalty is so ill-conceived as to be arbitrary and subversive of the self-assessment system. Though the penalty can be abated by "fully disclosing" questionable items, the bill fails to indicate just what constitutes full disclosure. The taxpayer would be penalized for the failure to accurately predict the eventual outcome of unsettled areas of law; he might also be penalized for the failure to recognize prospective areas of disagreement which might be raised after the return is filed. This standard of omniscience of both current and future issues is unreasonable.

Our self-assessment systems, which is working to a significant degree, is undermined by a no-fault provision that penalizes taxpayers who make a good faith effort to comply with the law. In this area, section 503 of H.R. 300 is a great improvement over section 125 of H.R. 5829. The surcharge imposed by section 503 can be waived by the Secretary if the taxpayer has acted reasonably and in good faith. Unfortunately, the bill does not define what is "reasonable". In addition, the level at which the surcharge triggers in is too low for most large corporations. One alternative may be to set the threshold at $10,000 and 10 percent of the year's tax liability.

These provisions would impose time and paperwork burdens on both the taxpayer and the revenue agents without adding to the efficiency or completeness of the audit process. The ABA respectfully suggests that the Committee might wish to tighten the existing fraud and negligence penalties as a more appropriate way to combat the actions of tax protestors and those who employ abusive tax shelter schemes.

CIVIL PENALTIES

Section 122 of H.R. 6300 and section 121 of H.R. 5829 would impose civil penalties on those who participate in the preparation of false or fraudulent tax returns. Section 122 applies to anyone involved and requires that the documents have been prepared in connection with complying with the internal revenue laws; section 121 applies only to corporate directors, officers, employers and advisors and does not require that the papers have been prepared in connection with the presentation of the tax return. The penalties imposed also differ substantially: section 122 would exact a fine of $5,000 for returns or documents in connection with the tax liability of a corporation whereas under section 121 the penalty is equal to 50 percent of the corporate underpayment resulting from the fraud up to $100,000 per participant.

The most troublesome portion of this proposal is the definition of "knowing participation" in section 121 of H.R. 5829 as "participation with respect to which such individual knew or should have known that such participation would result in an underpayment of tax". (Emphasis added) The ABA believes this standard is too vague and does not properly define fraudulent acts as only those which are intentional, willful and deliberately undertaken to defraud the government. We believe that if a party in question in good faith and with a reasonable basis takes a position that a rule or regulation does not adequately reflect the Code and accordingly does not follow the rule or regulation, then such person should not be guilty of fraud.

"Should have known" could impute knowledge to a tax manager where a position taken by a subordinate is later shown to be in error. In the ordinary course of business, a tax manager must rely on the judgments made by subordinates and cannot review in detail each and every decision made and position taken. In such a case, where in the ordinary course of the return preparation, the tax manager would not have knowledge of the specific action which lead to the understatement, would the manager nevertheless be guilty of fraud? Certainly the Congress cannot intend the IRS undertake to review the operating procedures of every taxpayer audited to determine if the procedures are reasonable, deviate in any way from any industry standards, and whether the industry standards are reasonable, to determine whether the manager should have known.

The tax laws are extremely complex and oftentimes vague. Corporations are already subject to a 50 percent civil fraud penalty and corporate officers, directors and managers are subject to criminal action and shareholder derivative suits. The ABA submits that sufficient penalties exist in current law to deter improper conduct.

MANDATORY REGISTRATION OF OBLIGATIONS

Section 102 would require that all Treasury obligations and all state and local tax-exempt bonds, issued after December 31, 1982, be issued in registered form. According to the Technical Explanation, this is necessary because unregistered obligations are used in commercial transactions as substitutes for cash, and thus may be used to conceal untaxed incomes or as a medium of exchange in illegal activities. The American Bankers Association is concerned that Federally mandated registration of municipal securities may lead to an erosion of the tax-exemption as we know it today.

The Technical Explanation states that a book entry system of registration will satisfy the requirement of mandatory registration of Treasury and municipal securities. It is felt that even though this will not impose significant problems for the issuance and registration of Treasury securities, it may have a detrimental impact on the market for municipal securities. Municipal securities are generally issued in bearer form, therefore registration of these debt obligations will modify the process of trading in these securities. This modification will result in increased issuance costs as well as costs associated with secondary transfers. These costs may be difficult for municipalities to absorb.

We also envision, initially, a disruption in the efficiency of these markets since there are likely to be a sufficiently large and diverse number of pre-1983 bearer obligations in the marketplace to compete with those post-1983 registered obligations. All things being equal, experience has shown that bearer instruments command a better price in the market.

The imposition of registration may affect liquidity of both the Treasury and municipal markets. Our concern lies in the possibility that potential investors, seeking ease of transferability and liquidity of bearer obligations for legitimate reasons, may look to alternative investments in offshore markets as a result of registration requirements. As a result, the marketability and liquidity of our domestic markets, markets which are currently the most efficient in the world, may be impaired.

We caution the members of the Committee that any alteration or modification to the financial market system of capital gathering and capital distribution may bring about changes which would seriously affect the efficiency of these markets. We recommend that, before registration requirements are imposed on such a large scale through Federal legislation, the Committee carefully study the potential effects of these proposals on the Treasury and municipal markets.

INFORMATION REPORTING

In a commendable attempt to minimize underreporting of income, the sponsors of both H.R. 6300 and H.R. 5829 propose expanding the information reporting requirements currently imposed on banks. The ABA strongly agrees with the sponsors of these bills that increased incentives must be developed to encourage better taxpayer compliance with the tax laws and reduce the magnitude of the underground economy. The ABA vigorously supports efforts to develop incentives to encourage taxpayers to report their income voluntarily and fully. The Association and its members have worked diligently over the years to improve the current information reporting system, for both the the bank operations and internal IRS procedures.

The expanding information reporting proposed by the bills appears, at first glance, to be simple and easy to provide. In actual practice, the proposed changes would be quite complex, costly, and time-consuming for banks and for consumers. Currently, the amount of interest accrued through the date of purchase of a bearer obligation is included in the price of the obligation. It would be difficult to develop a system to gather, analyze, process, and report the various components of the purchase price of such obligations, particularly where multiple purchases and sales of the same obligations are involved. The ABA believes that the resolution of this problem should be addressed by the Congress and not by regulations issued by the Internal Revenue Service. Because of the complexity of the problem, it could be necessary to restructure the marketplace and completely change the way in which business is done in the bearer obligation trading. Such fundamental changes in business practices, with important implications for capital markets generally, should not be undertaken by IRS technicians charged primarily with the duty of designing a reporting system to provide the greatest of information possible to the IRS.

Similar problems of complexity, market structure, and business practices of longstanding are presented by the proposal to determine and report the amount of original issue discount reflected in the purchase price of bearer instruments. Automated data processing system in use today track purchase and sale transactions separately from interest payment transactions. The integration of these two separate systems, plus the addition of a third system for reporting, would more than double the cost, it is expected, of current ADP operations devoted to original issue discount bearer obligations. This increase in cost would be passed on to purchases in the form of higher fees.

WITHHOLDING ON CERTAIN PAYMENTS WHERE TAXPAYER INDENTIFYING NUMBER MISSING

Section 213 of H.R. 6300 and section 124(c) of H.R. 5829 contain similar provisions which would impose withholding on certain payments where the taxpayer identification number is missing or inaccurate. These provisions would require all coupons paying agents to withhold on payments of interest on corporate bearer instruments. Presently because such instruments were issued in unregistered form there has been no reporting requirement under IRC sec. 6042. Virtually all corporate debt issued after 1967 has been in registered form and is subject to information reporting. As an example, one major bank has reported that of the over $36 billion in bond issues for which it acts as trustee, less than 1.7 percent is in bearer form. To gather the necessary information, to file information, and to determine if a proper TIN has been supplied would be extremely impracticable if not impossible based on present procedures.

In many cases coupons are presented for collection at branch offices of banks are processed through a correspondent bank who will then deliver the coupons accompanied by a due bill through a clearinghouse to the paying agent. If the branch at which the coupon was originally presented fails to obtain the information, there is no way for the paying agent to obtain it. If the paying agent then withholds 10 percent the payment will not match the amount of the due bill and the present system is unable to accommodate such discrepancies. An informal survey of ABA member banks which act as coupon paying agents indicated that entirely new systems would have to be put in place just to implement information reporting, much less institute withholding for the outstanding issues in unregistered form. Such systems would be very labor intensive and highly subject to error. Some coupon paying agents have informed us that the costs involved may be such that their only course of action would be to resign as coupon paying agent. Needless to say, this entire question of withholding on unregistered corporate debt, where an TIN is either missing or in error, will cause much confusion in an area which accounts for less than 2 percent of all corporate debt outstanding, a percentage which will be increasingly smaller over time. It would be the suggestion of the ABA that such legislation to require reporting and withholding on unregistered corporate debt by on a prospective-issue basis *only*.

With regard to the activities performed by our member banks who are dividend or interest paying agents for registered issues, again the administrative burden to withhold where there is no TIN or an incorrect TIN may prove to be excessive, with the result that may smaller transfer agent banks may leave the business. This business is very labor intensive with a narrow profit margin. One large transfer agent estimates that it will cost $750,000 to $1,000,000 to upgrade its system and data base to comply with the requirement to withhold. Further, the annual upkeep charges would run in the area of $350,000 for this agent alone. It is estimated that such costs could double or triple for smaller transfer agents. A question which the Committee should address is what will be gained by withholding where there is no TIN or an incorrect TIN.

A very large transfer agent has informed us that their system presently account for 93 percent of all taxpayers with a proper TIN. Further their statistical sampling indicates that the 93 percent account for 96 percent of the shares outstanding. This would seem to indicate that the shareholders who have failed to supply a TIN or have an incorrect TIN account for a very small portion of the total shares outstanding. A 1980 census study prepared by the New York Stock Exchange indicates that there are 39.6 million individual shareholders of record of American corporations. Applying the 7 percent factor to such a total suggests that over 2.7 million shareholders have failed to supply a proper TIN. The proposed provisions to require the more than 2,000 registered transferred agents in the U.S. to develop the system needed to withhold may well place this industry in turmoil which may never be fully resolved.

The cost incurred in developing and maintaining the systems to withhold are deductible expenses which may well more than offset any increased revenues. A possible alternative would be to report the names and addresses of those payees who have refused to provide their TINS to the IRS.

TRANSACTIONS OUTSIDE THE UNITED STATES

The provisions in Title IV are designed to reduce certain compliance problems that the IRS is encountering. This portion of the Act deals generally with access to books and records maintained outside the United States and with information returns to be filed by certain U.S. taxpayers engaged in foreign-related transactions.

Section 401 is not of direct concern to domestic banking operations. It is primarily aimed at U.S. persons who cannot be "found in" any Federal Court jurisdiction under the current rules regarding jurisdiction, presumably because they reside abroad. Under current law, the administration summons can be served abroad, but no U.S. court has jurisdiction to enforce the summons.

Act section 401 would add section 7701(a)(38) to the Code. This section would confer jurisdiction over such non-residents on the District of Columbia federal courts.

The ABA opposes this change in the law concerning administrative summonses. An administrative summons is issued without judicial oversight. Under the changes made by section 131 of the bill, which the ABA endorses, a taxpayer must bring an action to squash an administrative summons he wishes to resist. Assuming that the problem of actual notice to the taxpayer can be solved—and that is a large assumption—a taxpayer abroad would be put to an inordinate amount of expense and inconvenience. Further, because of potential delays in worldwide mail shipments, the taxpayer may not receive the notice within the period during which such an action may be brought.

Third party recordkeepers will find themselves in a dilemma with respect to such a summons on one hand facing enforcement actions brought in the District of Columbia courts and on the other facing civil or criminal liability for violation of a host country's privacy and bank secrecy laws.

Current methods of obtaining information with regard to Americans abroad, through the use of judicial subpenas, and exchange of information under bilateral income tax treaties, provide a more appropriate and effective means of dealing with this problem while respecting the substantive and procedural rights of citizens residing abroad. There are many jurisdictional and procedural questions raised by this provision. It should be examined with more care. At the very least, some provision should be made for judicial screening of overbroad requests.

Section 402 of the bill adds a new section 982 to the Code. Its general purpose is to enhance the IRS's access to books and records maintained abroad in connection with foreign activities of United States taxpayers. To accomplish this purpose, a new category of formal inquiry—a formal document request—is established and enforcement mechanisms are established, in the form of adverse presumptions and a requirement to maintain records in the United States in the future, to encourage compliance with formal document requests. The technical explanation suggests that the new section 982 was intended primarily to deal with the problem of closing the taxpayer compliance gap presented by the laundering of illegal receipts from trafficking in drugs, prostitution, and other criminal activities through the use of tax-haven jurisdictions. The actual incidence of the application of these provisions, however, may reasonably be expected to fall most heavily on foreign transactions, including all the cross border lending, of legitimate business operations of United States companies. It is extremely doubtful, furthermore, that these provisions would have a serious impact on the criminal tax evasion procedures allegedly employed by international traffickers in illicit narcotics, prostitution, and other criminal activities. The ABA believes that, as drafted, section 402 will create expensive, time-consuming, unnecessary, and burdensome operational, legal, accounting, and compliance problems for American businesses abroad, that it may well violate substantive and procedural rights of United States citizens abroad, and that it represents an impractical ineffective, and unnecessarily overbroad response to the problem to which it is addressed. Accordingly, the ABA opposes the inclusion of this section in legislation.

Under proposed section 982(a), a formal document request would be issued administratively. The request appears to be in the nature of an administrative summons, but, since section 401 of the bill establishes the Federal district courts for the District of Columbia as the appropriate venue for the enforcement of such summonses, and since no judicial proceedings are contemplated, it appears that a formal document request is something even less formal than an administrative summons.

Because the admissability of documents in a judicial proceeding is at stake, it is inconceivable that such a request should not be subject to review as to its adequacy, legitimacy, reasonableness, breadth, and relevence before issuance. Under section 982 a taxpayer who fails to comply substantially with such a formal document request would risk being precluded from ever introducing the requested document in court. While there is a provision for extensions of time and an exception for reasonable cause, the statute does not permit recognition of the risk of civil or criminal prosecution for violation of a foreign country's privacy or bank secrecy laws as reasonable cause. This is patently unfair, and, in a criminal proceeding, clearly could result in a denial of substantive due process. A taxpayer, particularly a third party recordkeeper such as a bank, may be unable to comply with a foreign document request because a foreign lawyer, accountant, or banker, for example, may be unwilling to violate his own country's laws. This provision, incidentally, goes far beyond present law. See, e.g., *Societe Internatinale Pour Participations Industrielles v. Rogers,* 357 S. Ct. 197 (1958) and *United States v. Vetco, Inc.,* 644 F 2d 1324 (9th Cir., 5/11/81).

Sections 982 (b) and (c) either represent an attempt to codify longstanding common law rules of taxation to the effect that the term "income" is to be construed as inclusively as possible, that exceptions, deductions, and credits are to be construed narrowly, and that it is up to the taxpayer to substantiate claims for deductions and credits, or a wholly unjustified attempt to bully taxpayers into mindless compliance with every whimsical request dreamed up by an international agent under the threat of presuming receipts to be income and denying deductions and credits for failure to comply. The draft, even when read against the technical explanation, is ambiguous. Could a taxpayer who refused to comply with a formal document request, due to the need for compliance with his host country's banking secrecy laws, establish by other evidence that gross receipts with respect to which the request was submitted do not constitute income?

Curiously, the provisions of this section place a premium on the destruction of records. A failure to comply with a formal document request by reason of impossibility would appear to be a reasonable cause; complying with the host country's laws is not. This would, of course, deny access to such records by the host country's auditing and tax authorities, shareholders, and other parties.

The judicial presumptions on income and deductions were formulated in the days of constitutional atacks on the existence of an income tax and, after by the 16th Amendment, on the definition of income. The courts made it clear early on that the Amendment was designed to end this quibbling and make the definition of income a statutory matter, not a matter of constitutional law. There is a clear risk in attempting to codify such general principles of law, i.e., that the statutory language will be construed less broadly than the principle and, more importantly, that the statutory language will freeze the continuing evolution of the concept.

Sections 982 (b) and (c) appear to go beyond the probable intent of the legislature and reflect an insensitivity to the relationship between the role of the common law of taxation (which includes such notions as substance vs. form, assignment of income, and the presumptions in question here) and the Code itself.

The presumptions are not related specifically to the "formal document request". Literally, they apply, whether such a request is made or not, to "any" U.S. person with respect to "any" foreign-related item. They therefore go beyond the evidentiary rule with respect to documentary evidence in court.

More broadly, the statutory presumptions, even if technically repaired, indicate a real insensitivity to the role of the judiciary in tax matters. Common-law rules exist to be administered flexibly by judges. Codifying such a rule, even though it is labeled a presumption, removes this flexibility, expecially where, as here, the standard for rebutting the presumption is not set forth.

It is especially ironic that this attempt at codification should occur now, where the courts are demonstrating a great deal of sophistication in dealing with sensitive international enforcement issues. The *Vetco* case, in which the Court recognized its duty to "balance competing interests" is an example. The Court put the burden on the taxpayer to show why the documents should not be produced, and, the taxpayer having failed to carry that burden, entered an order that the documents in question be produced.

The result was that Vetco got its day in court to test the reasonableness of the request before production of the documents was required, but the government ultimately prevailed. Vetco was thus in the same procedural posture as a domestic taxpayer would be, facing the same presumptions, and bearing the same burden of proof. It hardly seems unreasonable to allow the same procedural protections for foreign-related matters as for totally domestic ones. In other words, Americans doing business abroad should not be treated as second class citizens.

There are other, more technical, problems with this section. Does "foreign connected amounts received" include amounts accrued? Is it intended to mean all amounts realized? Is basis a "deduction, credit or other tax benefit"? Is it intended to apply to Subpart F income and foreign personal holding company income?

Finally, the new section would allow the Secretary to require any taxpayer who has run afoul of a formal document request to maintain books and records inside the United States. No standards are set forth as to how this rule is to be administered, there is no provision for administrative review, and there is no sanction for disobedience. There is a question of whether the records would be originals or copies. Could maintenance of all daily journal entries be required? What if the United States taxpayer is a minority share holder and, accordingly, does not have access to the books and records of the foreign company?

Section 6038 of the Code currently requires that a U.S. person who controls a foreign corporation provide the IRS with certain information. The penalty for failure to do this is a 10 percent reducton of the person's entire foreign tax credit. If the violation persist 90 days after the notification by the IRS, the reduction increases by 5 percent per 3-month period. According to the Joint Committee, this penalty is rarely enforced despite alleged inadequate reporting.

The solution chosen in the Act to remedy this problem is not to simplify the reporting requirements, but rather to "simplify" the penalty. The new penalty would be $1,000 per month per reporting period after the 90-day notice. The reduction in the foreign tax credit would not be eliminated, but the amount of the reduction would itself be reduced by the penalty.

The foreign tax credit penalty should be eliminated altogether. The Treasury Department concedes that it is complicated, burdensome, and usually unduly harsh. The fine proposed is more in proportion to the magnitude of the offense. If a greater penalty is called for, it should be applied based upon some recognized standard, such as wilfulness.

Section 905(c) requires that a taxpayer notify the IRS if a foreign tax for which a credit was taken is subsequently refunded or if the amount accrued is adjusted. It also states that no interest will be payable on the resulting deficiency until the refund, if any, is actually paid by the foreign government, except to the extent that the foreign government pays interest to the taxpayer. However, the interest due to the U.S. is not forgiven (whether or not the foreign government paid the interest) if the taxpayer fails to notify the IRS of the adjustment. This is different from the general rule on interest, which is that it is calculated from the date prescribed for payment of the tax.

The proposed change in section 414 of H.R. 6300 would be to eliminate the imposition of interest on these amounts althogether. The rule now in effect is unclear, because it does not state when the interest begins to run if the rule applies. Section

6689 also provides for a special penalty of up to 25 percent of the resulting deficiency for failure to report a redetermination of foreign tax without reasonable cause. While the penalty is severe, it is less severe than a penalty plus interest. The proposed change would be a step in the right direction.

WITHHOLDING ON PENSION PAYMENTS

Title III of H.R. 6300 would subject payments from qualified employee benefit plans to withholding. Subtitle D of H.R. 5829 contains a similar requirement but differs in the way individuals may elect not to have withholding apply and in other respects.

Presently payers of retirement benefits are required to file information returns which notify both the taxpayer and the government of amounts distributed from employee benefit plans. By claiming a $2.8 billion "tax gap" IRS is admitting its failure to make use of the information returns supplied, at significant expense, by banks and other payers of these benefits. Before requiring the private pension system to incur significant additional costs entailed in withholding, we urge the Service to utilize the information presently supplied to it to enforce compliance.

Testimony of William J. Anderson on behalf of the General Accounting Office stated

"IRS' studies show that—next to tax withholding—information reporting represents the single most effective tool for promoting taxpayer compliance in reporting legally earned income. Thus, we support cost-effective information reporting and follow-on computer matching programs."

ABA fully supports that statement. We believe that by requiring withholding, H.R. 6300 and H.R. 5729 go further than necessary to achieve compliance.

Our income tax law in its present form is complex and burdensome. Indeed many feel it is far too confusing and bewildering to permit comprehension. The recordkeeping and reporting requirements imposed by the income tax are already the most burdensome imposed by the Federal government.

According to OMB's 1982 Information Collection Budget, the two most burdensome forms imposed by the Federal Government are the income tax return and the wage and tax statement. In fact four of the twenty most onerous forms relate to the individual income tax. The intent of Congress in enacting the Paperwork Reduction Act of 1980 was to minimize the work burden imposed on the public and to minimize the government's cost of collecting information. The retirement withholding provisions fail to meet either of those Congressional goals. Rather they run directly counter to both. Retirement benefit withholding would increase the number of individual income tax returns where but for withholding none would be required and cause a new form for the withholding election. As a result, the proposal will greatly increase the burdens on elderly taxpayers, those who are least able to comprehend and cope with detailed and involved forms (and least likely to have access to competent tax advice) on plan administrators and trustees, and on the IRS itself. Moreover these burdensome provisions are not needed to obtain greater compliance.

If the Congress determines, however, that withholding on benefits from employee benefit plans is necessary then ABA urges that it be imposed in as administratively simple a manner as possible. Complexity requires more lead time, leads to additional possibility for error, increases costs and may result in noncompliance.

Election by annuitant

Each bill permits annuitants to elect not to be subject to withholding. In effect this is a reversal of current law which permits pension recipients to elect to have amounts withheld from their payments.

H.R. 5829 would require that the election "out of" withholding be made for each calendar year. Such a requirement will result in an administrative nightmare for plan administrators or those who make payments on their behalf. Each year notices will have to be sent to each of millions of retirees, and their return recorded. Printing and postage costs alone will be significant but more importantly extensive staff time will be spent processing the forms, responding to questions and explaining the requirement. To the extent possible, banks will pass these costs on to plan sponsors, but this additional administrative expense on top of all the other requirements imposed on employee benefit plans may only serve to discourage some employers from establishing or continuing their plans.

As burdensome as this election requirement may be for plan administrators and trustees, the confusion and dismay it will cause annuitants cannot be understated. Many will not read the notice, or understand it if it is read. Notices will inevitably be lost or not returned for many reasons, thus resulting in withholding where no tax is due.

H.R. 6300 is preferable in this regard for under its provisions notices need be mailed and processed only once. Elections, once filed, will continue to be effective until amended. Even a single notification to retirees that an election must be filed to avoid withholding will be burdensome to plan administrators and trustees and confusing to retirees. However, in addition to being less burdensome and costly to administer, single filing of the election will avoid withholding as a result of inadvertence or mistake on the part of retirees who do not understand the need for refiling an election each year.

Effective date

It will be all but impossible to comply with the effective dates proposed. H.R. 5829 would require withholding on payments made after December 31, 1982, while H.R. 6300 permits an additional three month delay in withholding. Even if it could be assumed that the bill were to be signed into law in July the effective dates provide too little lead time. Treasury must then develop tables, propose regulations for public comment, allow for the comment period (and possible hearing) prior to adopting final regulations. In addition, IRS must develop an appropriate form for the withholding election. All of these steps would have to be completed in time to allow plan administrators and trustees time to develop and/or modify computer programs (which alone can take many months), mailout election notices to pension recipients, and follow-up notices where no response has been received, take the completed elections back from pensioners, sort them and feed the information into the computers. All of this could not possibly be accomplished in time to implement the law by either of the dates proposed. It is unlikely that an effective date earlier than the end of 1983 could reasonably be met.

Withholding schedule

Both bills would require withholding on periodic payments as if they were wages. As a result it will be necessary to receive a W-4 Form declaring exemptions from each recipient who does not elect "out of" withholding. These exemption forms will require sorting, handling, and data entry resulting in more time and cost. Moreover, the computer systems needed to withhold at progressive rates will have to be more sophisticated and, consequently, more expensive. The programming will be more complex and time consuming. The Committee might wish to consider as an alternative a single withholding rate as more efficient and cost effective. A flat rate of withholding might, in addition, be implemented more quickly.

Mr. GUARINI. Thank you, Mr. Ator.

Our next witness is Mr. Alexander Zakupowsky of Deloitte, Haskins & Sells.

STATEMENT OF ALEXANDER ZAKUPOWSKY, JR., PARTNER, DELOITTE, HASKINS & SELLS

Mr. ZAKUPOWSKY. Thank you.

My name is Alex Zakupowsky, and I am a partner in the international public accounting firm of Deloitte, Haskins & Sells. We applaud the Congress and this committee for considering ways in which our laws can be improved to increase taxpayer compliance. However, as accountants and businessmen, we believe that before enacting such changes, they should be subjected to a very close cost-benefit analysis. We also wish to point out that it is our perception that the tax system works as well as it does because it is a self-assessment system, and there is a great deal of self-compliance.

We do not mean to understate the need for increased compliance, but only to put it in its proper perspective for purposes of our comments and point out that certain provisions included in the bill may actually backfire and decrease compliance in the long term.

I would like to just highlight some of the comments I have prepared and ask the chairman to include the entire statement in the record. The issues I would like to address are information reporting, the computation of interest on carrybacks, the penalty on substantial understatement of liability, and the admissibility of foreign-connected documentation.

Information reporting as we see it has a dual function in increasing taxpayer compliance. First, it provides the taxpayer with a document that reflects the amount of income to be reflected on a return, and second, it provides the Internal Revenue Service with the means of verifying that a taxpayer has reported an amount earned. It is against the ability to improve these two functions that the additional cost of expanded reporting must be compared.

In reviewing the expanded reporting requirements contained in the bill, we find that a number of them contain useless or inaccurate information and provide the IRS and the taxpayer with little help. I have cited a number of examples in the text of our comments. I would like to relate two of them to you.

One is that the expanded original issue discount reporting would require the entire amount of original issue discount accruing during a calendar year to be reported without reduction for any excess of purchase price paid by the taxpayer over the original holder's adjusted basis. This piece of information is of little use to the taxpayer in preparing a return.

Another example is that States would be required to provide taxpayers with information regarding refunds they have received on their State income taxes from the previous year. This again would be of little use to taxpayers who do not itemize deductions and are not required to take that amount into account in preparing their tax return. In short, taxpayers will be receiving documents of little use. Our fear is that it will lead to a presumed inaccuracy in information reports received by taxpayers and therefore taxpayers will learn to disregard some of the more useful documents, such as forms W-2 or 1099 received in the ordinary course.

We also believe that the Internal Revenue Service should put to use the forms which they are currently receiving. The IRS receives more information reports today than they can effectively match against filed returns. Based on information contained in the 1981 Annual Report of the Commissioner, some 222 million documents will be left unused this year. These documents, of course, were prepared at tremendous cost to taxpayers.

The second point I would like to address is the computation of interest on carrybacks. If enacted, this provision will create both an inequitable result and an extraordinary hardship for many taxpayers, and is contrary to congressional intent which granted corporate taxpayers the ability to extend the due dates of their corporate income tax returns for periods of up to 6 months.

The preparation of corporate income tax returns and claims for refund arising from net operating loss carrybacks is often an extremely complex and time consuming task. It is not uncommon for taxpayers to require the full extended 6-month period in order to file a complete and properly prepared return. If tax is due, interest is paid. If tax is refunded, interest should also be paid to the taxpayer.

This provision of the bill would also present an extreme hardship on accountants and other tax preparers whose clients would insist on having the returns filed by the original due date of the return. If the rules are going to be changed, we believe they should be changed with sufficient prospectivity to allow taxpayers and professionals to prepare for the accelerated filing dates necessary to avoid a loss of interest. I can tell you from the standpoint of my firm it would be impossible for us to prepare all the returns within the time period that our clients would like them prepared to get their money or have the interest start running. Furthermore, I believe the provision does not solve the problem, if one exists, where taxpayers delay filing carryback claims to take advantage of artificially high interest rates. Such taxpayers would still be given the opportunity of filing the return for the last year, holding back on filing the claim for refund, and accruing interest.

Any problem that currently exists is because the 20-percent interest rate is artificially high. This problem could be corrected by a more frequent updating of the rate of interest charged or paid to the IRS. Alternatively, interest could be stopped 1 year after the loss year is over, and I think this would put a stop to taxpayers holding off on filing claims for refund.

On the point of the substantial understatement of liability, the bill provides a no fault penalty of 20 percent of the interest charged, where it is the greater of 10 percent of the liability or $5,000. Because the penalty would be nondeductible, it is equivalent to an additional 7.4-percent interest charged a corporate taxpayer in the 46-percent rate. Therefore, the current interest rate is increased effectively from 20 to 27.4 percent.

With daily compounding, which the bill also calls for, this rate is escalated to 31.5 percent per annum. We believe that this rate is just too high to be assessed on a no fault basis. If Congress believes that greater penalties should be imposed on taxpayers that overreach the bounds of reasonable interpretation of the law, we would suggest that the current rules and penalties applicable to negligence and fraud be reexamined. It is inappropriate, we believe, to expand a no-fault penalty borne of the need to deal with aggressive tax situations to the good faith reporting of legitimate business transactions that may be reported inaccurately because of the complexity of our tax laws.

The final point I would like to make is on the admissibility of foreign-connected documentation. The bill provides for the exclusion of evidence where the taxpayer does not produce evidence because the foreign country prohibits disclosure. This penalizes the taxpayer for what is basically a government-to-government problem. We disagree with the provision, first, because it is unrealistic to expect a taxpayer to disregard foreign law; second, because the provision does raise Federal constitutional problems; and finally, because we believe the existing Federal rules governing disclosure provide more than adequate safeguards against surprise at trial.

Thank you.

[The prepared statement follows:]

STATEMENT OF ALEXANDER ZAKUPOWSKY, JR.

My name is Alexander Zakupowsky, Jr. and I am a partner in the international public accounting firm of Deloitte Haskins & Sells. We welcome this opportunity to present out views on "The Tax Compliance Act of 1982" introduced by the Chairman of this Committee.

We applaud the Congress and this Committee for considering ways in which our laws can be improved to increase taxpayer compliance. However, as accountants and businessmen we believe that before enacting such changes they should be subjected to a very close cost/benefit analysis. We also wish to point out that it is our perception that the tax system works as well as it does because it is a self-asessment system and the large majority of taxpayers do report their income properly. This point was made by former IRS Commissioner Kurtz when explaining the report entitled "Estimates of Income Unreported on Individual Income Tax Returns" in the Commission's 1979 Annual Report:

"The report estimates that individuals failed to report $75 billion to $100 billion in income from legal activities . . .

"To put these figures in context in the same tax year individuals voluntarily reported nearly $1.1 trillion in income . . ."

This indicates an overall compliance of 91-percent.

We do not mean to understate the need to increase compliance but only to put it in its proper perspective for purposes of our comments and point out that certain provisions included in the bill may backfire and actually decrease compliance in the long term.

INFORMATION REPORTING

Information reporting has a dual function in increasing taxpayer compliance. First, it provides the taxpayer with a document that reflects the amount of income to be reported. Second, it provides the Internal Revenue Service with a means of verifying that a taxpayer has reported an amount earned. The first function assists the taxpayer in complying with the law while the second allows for verification. It is against the ability to improve these two functions that the additional cost of an expanded reporting system must be compared.

In reviewing the expanded reporting requirements under the bill it appears that a number of information reports containing useless or inaccurate data would be provided to taxpayers and the IRS. For example:

(1) The expanded original issue discount reporting would require the entire amount of OID accruing during the calendar year to be reported without reduction for any excess of the purchase price paid by the taxpayer over the original holder's adjusted basis.

(2) Under regulations, interest or OID could be reported in full at maturity without regard to the amount of time the taxpayer held the obligation.

(3) Under regulations, securities and commodities brokers could be made responsible for reporting transaction details including gains and losses without the requisite information regarding identification of securities or commodities sold or the basis of such property.

(4) Payments by business for services performed would be reported on a cash basis and may not be reported in the proper period for accrual basis txpayers.

(5) States would be required to report income tax refunds even though a large majority of taxpayers do not itemize deductions and therefore do not have to report the refund as income.

In short, taxpayers will be receiving documents of little use to them in preparing their tax returns or with the wrong numbers on them.

As a result many taxpayers will be led to misstate their income because of the receipt of an "official form". This will increase the number of instances in which the IRS and taxpayers must communicate to reconcile differences at a significant cost to both taxpayers and the IRS. Over a period of time taxpayers will become aware that the "official forms" can't be trusted and some will question their accuracy without regard to the type of information reported. There could be an adverse public reaction to all information reports and as a result the more useable forms, such as From W-2 reporting wages and Form 1099 reporting dividends or interest, would no longer be presumed accurate.

We also question the advisability of providing more reporting to the IRS. The IRS receives more information reports today than it can effectively match against filed returns. The 1981 Annual Report of the Commissioner states that only 26 percent of the information returns submitted as paper documents will be compared to returns. Over 300 million paper documents are filed and consequently 222 million will be left unused. These documents were prepared at tremendous cost to taxpayers. There is a serious question whether increased administrative burdens and costs should be placed on business to assist the IRS in its enforcement role when such a large number of documents are currently of no use to the IRS. Furthermore, the Commissioner has acknowledged that approximately 37 percent of unreported diviends and interest payments are covered by current information reporting requirements. It would seem that our attention and National resources would be better consumed in making more use of the documents already prepared than increasing the number of forms that cannot be processed.

We believe that Congress should be guided by the following considerations before increased reporting requirements are added to the government imposed paperwork burden on business:

(1) Information reports supplied to taxpayers should provide data that can reliably be used directly on tax returns without modification.

(2) Information reports supplied to taxpayers should not duplicate information supplied to payees on customer statements.

(3) Information reports should be required only to the extent the IRS has the ability to make use of the information.

COMPUTATION OF INTEREST ON CARRYBACKS

Under present law, interest on a tax refund arising from a net operating loss (capital loss, investment credit, etc.) carryback runs from the day after the end of the loss year to a date not more than 30 days before receipt of the refund. Under the bill interest would run from the due date of the return for the year in which the carryback arose. This due date would include extentions.

If enacted, the above provision will create both an inequitable result and extraordinary hardship for many taxpayers and is contrary to Congressional intent which granted these corporate taxpayers the ability to extend the due dates of their corporate income tax returns for periods of up to 6 months.

The preparation of corporate income tax returns and claims for refund arising from net operating loss carrybacks is often an extremely complex and time consuming task due, in part, to the many variances between income and expenses reported for financial accounting purposes and taxable income and deductions under the Internal Revenue Code. For large corporate groups, the complexity is exacerbated by the filing of consolidated tax returns involving inter-company transactions and eliminations and a host of other problem areas. It is for this reason that Congress enacted the provision providing an automatic 3-month extention. An additional 3-month extension of time is permitted upon an appropriate request made to and approved by the IRS.

Based on the above, it is not uncommon for taxpayers to require the full extended 6-month period in order to file a complete and properly prepared return.

This provision of the bill would also present an extreme hardship on accountants and other tax return preparers whose clients would insist on having their returns filed by the original due date of the return. This would be especially true if the effective date suggested in the bill, which is date of enactment, were adhered to. If the rules are going to be change, they should be changed with sufficient prospectivity to allow taxpayers and professionals to prepare for the accelerated filing dates necessary to avoid a loss of interest.

Furthermore, the provision does not solve the problem, if one exists, where taxpayers delay filing carryback claims to take advantage of an artificially high interest rate. Such taxpayers would still be given this opportunity by filing the return for the loss year by the original due date but delaying the filing of the carryback claim.

The present provisions governing the applicability of interest on carrybacks are fair and do not penalize taxpayers who are unable to prepare returns without utilizing the extended time period permitted by the Internal Revenue Code. These provisions were well thought out at the time the 1954 Code was enacted to rectify some of the problems that the proposed legislation will recreate.

Any problem that currently exists is because the 20 percent interest rate is artificially high. This problem can be corrected by a more frequent updating of the rate of interest charged by or paid to the IRS. Alternatively, the Code could be amended to provide that interest, beginning on the day after the end of the loss year, will cease one year after the close of the loss year unless prior to that date a claim for refund is filed.

SUBSTANTIAL UNDERSTATEMENT OF LIABILITY

The bill provides for a "no-fault" penalty where there is the greater of a 10 percent or $5000 understatement of a taxpayer's actual tax liability. The penalty is set at 20 percent of the applicable interest on the underpayment. Because the penalty would be non-deductible it is equivalent to an additional 7.4 percent interest charged a corporate taxpayer with a 46 percent marginal tax rate (7.4 percent = 4 percent ÷ (1− 46 percent)). Therefore, the current interest rate of 20-percent is increased to approximately 27.4-percent by this provision. Furthermore, since the bill also provides for daily compounding of interest the annual effective rate is increased from 20-percent to 31.5 percent for taxpayers that are subjected to this new penalty.

We believe that this rate is too high to reasonably charge on a no-fault basis.

Most taxpayers attempt to determine their proper tax and much of the blame for high deficiencies, when they occur, is due to the complexity of our tax laws, the delay in the issuance of regulations and the inability of the IRS to resolve technical problems on a prompt basis.

If Congress believes that greater penalties should be imposed on taxpayers that overreach the bounds of reasonable interpretation of the law, we would suggest that the current rules and penalties applicable to negligence and fraud be re-examined. It is inappropriate to expand a no-fault penalty, born of the need to deal with aggressive tax shelter situations, to the good faith reporting of legitimate transactions.

ADMISSABILITY OF FOREIGN CONNECTED DOCUMENTATION

The bill allows a court to prohibit the introduction in court by a taxpayer of documentation related to foreign transactions if that documentation had previously been requested by the IRS but not provided to the IRS by the taxpayer. An exception to this harsh rule is provided if the taxpayer can show reasonable cause for failure to produce the requested documentation.

However, if a taxpayer did not disclose the requested documents because the foreign country where business is conducted imposes civil or criminal penalties for such disclosure, this will not constitute reasonable cause. Also, any foreign-connected item affected by this documentation is presumed to be income and any foreign-connected deduction, credit, or other tax benefit is presumed to be unallowable. These presumptions and the exception to reasonable cause should be deleted because; (1) it is unrealistic to expect that a taxpayer doing business in a foreign country is free to ignore the civil and criminal penalties imposed by that country, (2) the provisions raise Federal constitutional problems, and (3) the existing Federal rules governing disclosure provide more than adequate safeguards against surprise at trial.

Thank you for the opportunity to present these views on this important topic.

Mr. GUARINI. Thank you very much.

Mr. Dwight C. Moorhead, of the Petro-Lewis Corp. Welcome, sir, and please proceed.

STATEMENT OF DWIGHT C. MOORHEAD, VICE CHAIRMAN AND CHIEF FINANCIAL OFFICER, PETRO-LEWIS CORP.

Mr. MOORHEAD. Mr. Chairman, thank you for granting us the opportunity for me to appear today. My remarks will be brief, but may I request that my prepared statement be made a part of the record?

Mr. GUARINI. They so will.

Mr. MOORHEAD. I am Dwight Moorhead, vice chairman and chief financial officer of Petro-Lewis Corp. We are a Denver oil company which acts as general partner for over 100,000 different individual investors and partnerships formed to purchase and operate established, already producing oil and gas properties. Our investors' objectives are yield checks in the mail rather than tax shelter.

With respect to its partnership audit provisions, we strongly favor the concepts of H.R. 6300. Given the proposed processes and elections, we see no serious potential for unfairness to individual partners, and we do foresee major improvement in the administration and adjudication of tax matters for large partnerships.

Further, inequities in treatment of our partners in various Internal Revenue Service districts that result from variations in administrative policies in those districts will be ended, and this is a very important fairness issue and perception of fairness issue.

Finally, the costs of compliance borne by partners, and it is a very, very material cost, would be reduced and the cost to the Government for audit collection would be dramatically cut.

In addition to that subject, I would like to recommend consideration of a further application of a similar concept. That is, the inclusion of a provision in H.R. 6300 for the administration, adjudication, and collection of the windfall profits tax from oil production of a partnership by designating the partnership as a producer of oil for this limited purpose.

We now provide millions of pages of data annually to our partners in order for them to make windfall profits tax filings with the IRS. By providing for the windfall profits tax to be handled at the partnership level, the general partner, the limited partners, and the Internal Revenue Service can realize savings of many millions annually simply from the administration of this tax on our 100,000 partners.

Note that this would go beyond the audit and adjudication process for partnerships now a part of H.R. 6300. We deem this to be appropriate because the windfall profits tax is an excise tax levied on the basis of a partner's generally unchanging status and their share of partnership oil produced unrelated to any other income or expense items outside the partnership affairs.

Therefore, the administration is possible at the partnership level, as collection, audit, and adjudication matters are, and this would be to the benefit of the partners and the IRS alike.

To reemphasize, both the partnership audit provisions now a part of H.R. 6300 and the concept of windfall profit tax administration at the partnership level will facilitate compliance, collection, audit, and adjudication, and very substantial savings to taxpayers directly and indirectly through the elimination of IRS paperwork and expense. Government revenues would almost certainly be increased. So, again, thank you for this opportunity.

[The prepared statement follows:]

STATEMENT OF DWIGHT C. MOORHEAD

Good morning. My name is Dwight Moorhead. I am the Vice Chairman and Chief Financial Officer of Petro-Lewis Corporation. I appreciate this opportunity to appear before your Committee today in order to provide our views on the Tax Compliance Act of 1982. First, I wish to focus your attention on the partnership audit proposal. This proposal is designed to simplify partnership audits by consolidating the administration and adjudication of partnership items at the partnership level. The proposal is one in which Petro-Lewis has a substantial interest and which we strongly favor. Second, I want to recommend certain administrative amendments designed to simplify the administration, adjudication, and collection of the windfall profit tax by consolidating those activities at the partnership level.

Petro-Lewis is a publicly held company that, as general partner, acts as the principal operating agent for a large number of federally registered partnerships. Petro-Lewis serves over 100,000 different limited partners, and our partnerships range in size from a few hundred to over fifty thousand limited partners. The vast majority of our limited partners are individuals who own interests in several of our partnerships.

Our partnerships are essentially oil and gas income programs. Each partnership holds beneficial interests in numerous producing oil and gas properties. By purchasing a share in a Petro-Lewis partnership, an individual is able to invest in a diverse group of producing properties and earn an attractive rate of return while minimizing risks normally associated with ownership of only one or a few oil or gas properties. I must emphasize that our partnerships are not designed to act as a traditional tax shelter. The profitability of our limited partners' interests does not depend on income tax incentives to any significant extent. Rather, it depends mainly on the proper and sound selection, evaluation, and purchase of properties, the efficient production from them, and sound management of the properties and the partnership's financial affairs.

Yet a sizable dollar amount of the administrative costs for our partnerships is associated with tax compliance. Periodically, we must prepare and mail a myriad of tax forms, letters, and explanations to our partners. Because we have over 100,000 different limited partners, and because each partner may own interests in thousands of oil or gas properties, the burden associated with tax compliance is a substantial cost of our operations.

Moreover, this burden is exacerbated whenever we have a legitimate dispute with the Internal Revenue Service over a partnership item. The disputed item must be processed separately for each of our limited partners in the various IRS districts. Because each processing district is very autonomous, our limited partners in different districts will often receive inconsistent treatment with respect to partnership audit issues. Occasionally, partners are forced by the premature actions of an IRS district office to act on an issue before it has even been resolved at the district office in which the partnership is located. The resulting confusion and administrative and legal costs detract from the acceptance of our limited partnership interests as potential high yield, nontax shelter investments.

For these reasons, Petro-Lewis welcomes the proposal before this Committee to consolidate the administration and adjudication of partnership items at the partnership level. We believe that the proposed changes would benefit Petro-Lewis and our limited partners by simplifying needlessly complex administrative and adjudicative procedures, thus reducing administrative and legal costs for everyone.

Turning now to my second point, we would like to present to the Committee a proposal by which the administration, adjudication, and collection of the windfall profit tax could be consolidated entirely at the partnership level. Basically, we propose to treat large limited partnerships as the "producers" of taxable crude oil. The change would be effective only for purposes of windfall profit tax administration, adjudication, and collection. The amount and qualification of partnership production as independent producer oil or exempt oil would still be determined by reference to the status of the partners themselves. Consequently, the proposal would neither increase nor decrease the amount of tax imposed on partnership production.

The benefit from such a change is in the resulting administrative simplification. The limited partnerships would benefit because they would no longer have to provide to partners the large amount of detailed information required to be provided annually for windfall profit tax purposes under the current system. For Petro-Lewis alone, the savings in mailing, processing, and other administrative costs would amount to several million dollars each year. Our limited partners would benefit from the change because they would not be burdened and aggravated by this inordinately complex paperwork imposed on them by the Federal Government. Moreover, the costs associated with this effort are ultimately borne by our partners, directly when they pay their own lawyers or accountants to prepare or review tax returns or refund claims and indirectly when the additional administrative costs are incurred by their partnerships. Finally, the IRS would benefit because it could handle its refund claims at the partnership level where the information needed to audit the claim is readily available, instead of at the partner level where the information is fragmented. Equally important to the IRS, any deficiencies could be assessed against and collected from the partnership in a lump sum, instead of being assessed against and collected from numerous individual limited partners in much smaller fractional amounts.

We hope you will give our proposal further consideration. A close examination of the proposal will reveal that it is far superior to the current system of windfall profit tax administration for large limited partnerships. We would be pleased to provide additional information on it to you or your staffs at your convenience.

Mr. GUARINI. Thank you, Mr. Moorhead.

Mr. Duncan.

Mr. DUNCAN. I have no questions. I want to thank the panelists for their presentations.

Mr. GUARINI. Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

I would like to ask Mr. Ator, here representing the American Bankers Association, a similar question to the one I asked Mr. Epstein on the panel before him. I suspect as the tax counsel for the American Bankers Association, you may not be aware of the sales and marketing of that trade association for individual retirement accounts. Do you feel you can answer the question of whether or not section 311 of H.R. 6300, increasing the early withdrawal penalty from 10 to 15 percent, would or would not affect the sale of individual retirement accounts or the setting up of IRA's?

Mr. Ator. Mr. Moore, as you suggest, that is something that a different area of ABA would make a judgment on. I suspect personally that whenever the taxpayer decides he would like to take the money out, he is going to weigh the benefit of cashing out his IRA against the penalty he has to pay. You are increasing the toll charge from 10 to 15 percent. That is going to make a greater difference, the larger the amount in the IRA.

Mr. Moore. Of course, the question we are looking at is the initial setting up of the IRA, whether that toll charge would prevent him from setting it up even though he might feel he would have to go into the IRA at some point, whereas upper middle income groups might never find that a necessity, and therefore might never find going from 10 to 15 percent a problem.

I understand you requested in your testimony that you be allowed the opportunity to give this committee additional information coming from the ABA on H.R. 6300? Is that right?

Mr. Ator. Right.

Mr. Moore. Would you contact the marketing division of ABA and ask them this question, and give us that information as well?

Mr. Ator. I would be delighted to supply that information to the committee.

Mr. Moore. Mr. Chairman, I ask that the record be held open so that we can receive this information from the American Bankers Association.

Mr. Guarini. So ordered.

Mr. Moore. Thank you, Mr. Chairman.

[The information was never received.]

Mr. Guarini. Mr. Ator, you said that if we registered our bonds, that it would drive investors offshore. You feel that the investments would be put into offshore corporations in Europe or other areas in order to avoid income taxes?

Mr. Ator. Our comments here are preliminary. We know that there is a large offshore investment market.

Mr. Guarini. But what would be the motive if a person did not want to register his bond? Why the big secret if he was really up front and wanted to pay his taxes?

Mr. Ator. I suspect the answer has more to do with human nature than with paying taxes.

Mr. Guarini. They are both involved, you know. They are intertwined, human nature and not wanting to pay taxes. I do not want you to separate them so easily.

Mr. Ator. Well, the registration of a tax exempt instrument would simply mean that it is still tax exempt, so the taxpayer would owe no taxes on it. That is a result that could be obtained.

Mr. Guarini. Are they all not taxed? All the bearer bonds are tax exempt that we are talking about?

Mr. Ator. As I understand H.R. 6300, the registration of the obligation of future issues would be essential to their being tax exempt.

Mr. Guarini. Capital gains would be paid on it.

Mr. Ator. Yes.

Mr. Guarini. So do you think that the motives of people that you suggest would be driven offshore into foreign markets would not be pure?

Mr. Ator. I am sure that in many cases it would not be pure. I am sure in many cases it would simply be a desire not to get any more involved with the Government than they have to.

Mr. Guarini. I do not understand why the American Bankers Association would want to defend that kind of posture. I could see saying that it is burdensome, that it is not cost efficient, but I do not see the argument that we would drive them out of the country unless we want to defend the people who are the great offenders of our tax system.

Mr. Ator. Let me be clear about that. I am not defending that kind of behavior.

Mr. Guarini. All right. Clear up the record.

Mr. Ator. It has been suggested that one reaction in the bond buying public to the registration requirement might be that some portion of that market would go offshore. The reason I raised that point is that, depending on how much of the market went offshore, you would have an impact, you could have a potential impact on the liquidity of the bond market, as well as denying those investment funds to the State and local governments who issue the bonds.

Mr. Guarini. OK. Thank you very much, sir. I want to thank the panel for their advice and help, and for taking the trouble of coming here today and giving us your testimony.

Mr. Ator. I would like to have my prepared statement made a part of the record.

Mr. Guarini. Yes. Would you please give it to the reporter so that we can put it into the record?

Thank you, gentlemen.

Mr. Adrian Collins of ERISA Industry Committee, Mr. James M. Hacking of the National Retired Teachers Association, Mr. Robert Georgine of the National Coordinating Committee for Multiemployer Plans, Mr. George D. Cowles of the Assocation of Private Pension and Welfare Plans.

Mr. Collins. Mr. Chairman, I am Mr. Collins. We have agreed with the other witnesses on this panel, with your permission, that I will go last in the interest of orderly presentation, and Mr. Georgine will be first.

Mr. Guarini. You will be the anchor man.

Mr. Collins. Yes. Mr. Hacking will follow Mr. Georgine, and then Mr. Cowles.

Mr. Guarini. It is good to see you again, Bob. Do you want to start?

STATEMENT OF ROBERT GEORGINE, CHAIRMAN, NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS

Mr. GEORGINE. OK, fine, Mr. Chairman.

I appreciate very much the opportunity to testify before the House Ways and Means Committee with respect to H.R. 6300, the Tax Compliance Act of 1982. I appear before you in my capacity as chairman of the National Coordinating Committee for Multiemployer Plans. The coordinating committee is a nonprofit corporation organized to represent the interests of the 8 million participants in collective bargaining multiemployer plans. The coordinating committee has over 140 affiliates, including major pension and welfare plans, local Taft-Hartley trust and affiliated international labor organizations.

Mr. Chairman, we are in full agreement with the overall goals of the legislation and this committee. Better compliance with the existing tax laws will not only promote a sense of equity among the vast majority of taxpayers who do bear their full shares, it will help to avoid the necessity of imposing new taxes, a prospect that no one can relish.

Notwithstanding our support for the legislation's overall goals, we do have very serious concerns about the provisions for withholding on pension benefits paid to retirees and their survivors. If these provisions were to raise additional tax revenues, I fear that much of it would come from the unsophisticated, sick, or ill-informed pensioners who actually have no tax liability. Overwithholding is particularly likely in the context of multiemployer plans where benefits are quite modest. In my view, the likelihood of unfair overwithholding greatly outweighs the minimal revenue gain that these provisions seem likely to produce.

We recognize that pensioners could, under the proposed legislation, elect not to have tax withheld. However, where notice was not received by the pensioner or the election was not received by the plan, or the recipient failed to make an election, tax would be withheld automatically.

Mr. Chairman, we have many healthy retirees. Unfortunately, others are mentally or physically disabled. Some are in nursing homes. Some are confined to their apartments or houses. The withholding system proposed assumes understanding of the notice of election and a rational decision based on individual tax situations. The unfortunate fact of life is that many retirees cannot do this. No matter how well communications to retirees explain these provisions, many pensioners will mistakenly fail to make the election. Those who fail to understand the election procedure may also fail to understand their right to file for a refund at the end of the year. I believe that the Treasury is better off without the shameful windfall that it would receive in such situations.

We cannot try to balance the budget on the backs of our elderly retirees. Pensioners and much of the rest of this Nation are likely to be outraged over any such attempt.

A lesser, though very real, concern I have involves the additional costs and burdens the proposal could impose on plans. Collectively bargained plans such as ours have a fixed pool of resources. Anything eaten up in costs has to come out of the benefits that could otherwise be paid.

The annual election procedure in the bill pending on the Senate side would be an administrative nightmare for the plans and could impose enormous costs. In this respect, the single election procedure of H.R. 6300 is a marked improvement.

Nonetheless, under H.R. 6300 plans would have to notify pensioners of the election procedure, keep track of the elections, calculate the amounts to be withheld, presumably based on additional information from the pensioner as to the number of his exemptions, et cetera.

Plans would also have to respond to inquiries about the procedure and deal with the outrage of those whose benefits are reduced through failure to understand and make the election against withholding. For plans with tens of thousands of pensioners these costs could be substantial.

Mr. Chairman, I believe that the vast majority of the pensioners, like the vast majority of our citizens generally, try to comply fully with their obligations to pay taxes. As to any pensioner who does consciously avoid his taxpaying responsibilities, however, the pension provisions of H.R. 6300 are not likely to have an effect. Such a person would surely elect against withholding. Again, my fear is that the honest but unsophisticated pensioner who owes no tax is the one most likely to be end up paying under this proposal.

In conclusion, Mr. Chairman, we urge the consideration of alternative approaches. If there is, in fact, a compliance problem with respect to pension benefits, we urge that it be dealt with through more effective enforcement. Under current law, plans are required to file information returns with the IRS. Better utilization of this data, together with new reporting requirements, if needed, would be vastly preferable to the current proposals on withholding.

If withholding proposals do go forward, we believe that they should be effective only as to pension benefits that at an annual rate exceed some floor amount. An appropriate floor might be the maximum amount of income that can be earned by a married couple 65 or over without being subject to Federal income tax. The professional staff of the coordinating committee would be pleased to work with you in exploring any alternative approaches.

I thank the committee for this opportunity to appear.

Mr. GUARINI. Thank you, Mr. Georgine.

Have you decided your next order, or shall I call on Mr. Hacking?

STATEMENT OF JAMES M. HACKING, ASSISTANT LEGISLATIVE COUNSEL, NATIONAL RETIRED TEACHERS ASSOCIATION AND AMERICAN ASSOCIATION OF RETIRED PERSONS; ACCOMPANIED BY STEVEN ZALEZNICK, LEGISLATIVE REPRESENTATIVE

Mr. HACKING. Thank you. I am accompanied this afternoon by Mr. Steven Zaleznick, who is one of the associations' legislative representatives. We are here representing both the National Retired Teachers Association and the American Association of Retired Persons. These two organizations have a collective membership now well in excess of 13 million persons aged 55 and older.

With the associations' statement included in the record, I shall summarize.

Given the dangerously high levels of projected Federal deficits and the potentially calamitous consequences those deficit projections could have on prospects for recovery and revitalization of the economy, efforts to raise revenue must be actively pursued. Obviously, in this respect, every effort must be made to get people to pay the taxes they legitimately owe.

However, various tax compliance proposals must be carefully reviewed to make sure that they do not cause more problems than they solve. The associations are particularly concerned with those sections of H.R. 6300 and H.R. 5829 which affect pensions and other retirement income. While a proposed change to automatic withholding entails some positive features, the associations believe that it also presents unacceptable risks of confusion, paperwork, and especially overwithholding for large numbers of retirees.

Our primary concern is the effect on annuitants and pensioners who are used to the existing system of tax compliance or who have not been part of the tax system because of inadequate taxable income. This legislation would shift a burden onto these retirees to comply with the process for exemption for automatic withholding in order to maintain their current level of pension payments.

We can reasonably expect that for a variety of reasons many retirees who do not owe taxes will not avail themselves of their right to opt out of withholding and end up being overwithheld. At the same time, the proposed withholding and exemption procedures will impose costs on the payers of benefits. And obviously, what will have been expended for the purposes of disclosure, reporting and notification will obviously not be available for the payment of benefits.

In comparing the two bills, the associations feel that H.R. 5829 would create a significantly greater paperwork burden and opportunity for overwithholding by requiring that the election option be renewed annually. Also, H.R. 5829 is more rigid in its treatment of lump-sum distributions.

Senator Dole, in introducing the companion bill to H.R. 5829 reported that the tax gap for pension distributions is somewhere in the neighborhood of $3 billion. Although no indication is given of the revenue to be gained through the automatic withholding provision, Senator Dole's figures do indicate the existence of a significant compliance problem.

In attempting to resolve that problem, the associations believe an augmented voluntary approach ought to be pursued. This should include improved reporting and enforcement as well as a requirement for payors to notify retirees of their right to elect withholding. If the committee decides to go this route, the associations will do whatever is possible to inform our members of the taxable nature of pension distributions and of the choice between withholding and paying estimated taxes that needs to be made in the case of those who have tax liability.

We think much of the compliance problem in this area could be resolved if current practices were tightened up. Should the committee find that the automatic withholding approach adopted by the bills is absolutely essential, the potential for overwithholding has to be addressed. Certainly, exempting small periodic pensions from automatic withholding would be clearly called for. Persons with relatively small pensions who are not likely to have any Federal income tax liability should not be faced with the burden of having to elect out of automatic withholding.

The associations believe that the withholding provisions of H.R. 5829 and H.R. 6300, as currently drafted, present unacceptable risks of overwithholding to many vulnerable retirees who rely upon their pension benefits to meet the day-to-day costs of living.

We therefore have no choice but to oppose those provisions as they presently stand. However, we shall try to work with the committee and other interested parties in the effort to lessen whatever tax compliance problem may exist, but in ways that do not create hardships for those who do not have any tax liability.

That concludes my statement. I thank you.

[The prepared statement follows:]

STATEMENT OF THE NATIONAL RETIRED TEACHERS ASSOCIATION AND THE AMERICAN ASSOCIATION OF RETIRED PERSONS

I. INTRODUCTION

The National Retired Teachers Association and the American Association of Retired Persons appreciate the opportunity to testify on "The Tax Compliance Act of 1982" and related legislative proposals before the Ways and Means Committee. Given the dangerously high level of federal deficits for the foreseeable future, efforts to raise revenues must be actively pursued. A priority method for raising revenues should be getting people to pay the taxes they legitimately owe. However, various tax compliance proposals must be carefully reviewed to make sure they do not cause more problems than they resolve.

The Associations are particularly concerned with those sections of HR 6300 (Chairman Rostenkowski's "Tax Compliance Act of 1982") and HR 5829 (Congressman Conable's "Taxpayer Compliance Improvement Act of 1982") which affect pensions and other retirement income. HR 6300 and HR 5829 would change the current voluntary compliance method for paying taxes on this form of income. While these changes introduce some positive features into the taxpaying system, the Associations believe that they also present unacceptable risks to a significant segment of the retiree population.

II. ANALYSIS OF THE PENSION WITHHOLDING PROVISIONS AND THE PROBLEMS THAT RESULT

Section 131 of HR 5829 would require a payor to withhold from annuity payments in a similar manner to current wage withholding practices. Recipients of periodic pension payments could elect not to have withholding. According to the legislation, regulations will be issued to require plan sponsors to notify retirees of their right to elect out of the withholding process. This election will have to be renewed annually. Lump sum distributions would be withheld at a fixed rate, and recipients of this form of payment will not have an opportunity to elect out of withholding unless they make a tax-free rollover of the proceeds.

Title III of HR 6300 contains similar annuity withholding provisions, with some modifications. Under HR 6300, an election form would not have to be renewed annually. Additionally, greater flexibility is set in determining the withholding level for lump sum distributions, and recipients of this form of payment will be allowed to opt out of withholding.

After carefully reviewing the proposals before the Committee the Associations have concluded that they run the risk of causing confusion, overwithholding and paperwork burdens for many retirees. Our primary concern is the proposal's effect on annuitants who are used to the existing system of tax compliance or who have not been a part of the tax system because of inadequate income. This legislation would shift a burden onto these retirees to comply with the exemption process in order to maintain their current pension payment. We can reasonably expect that, for various reasons, many retirees who do not owe taxes will not avail themselves of their right to opt out of withholding.

In comparing HR 6300 with HR 5829, the Associations feel that HR 5829 would create a significantly greater paperwork burden and opportunity for overwithholding by requiring that the election option be renewed annually. Also, HR 5829 is more rigid in its treatment of lump sum distributions, a position which could cause complications for people who elect to receive this form of retirement benefit.

The pension withholding provisions will produce some benefits for annuitants with tax liability. They will be made aware of the opportunity to have withholding, and their reliance on the cumbersome estimated tax process will thereby be lessened. However along with these benefits proposed legislation produces an unacceptable cost to retirees who do not owe taxes yet who would be thrust into a complicated taxpaying system.

III. POTENTIAL SOLUTIONS TO THE COMPLIANCE PROBLEM

Senator Dole, in introducing S 2198 (which is identical to HR 5829) reports that the compliance gap for pension distributions is approximately $3 billion, and it is expected to sharply increase in the future. Although no indication is given of the revenue to be gained through the withholding provision, Senator Dole's figures do indicate the existence of a potential compliance problem. However, the Associations hope that the Committee does not resolve this problem by jeopardizing the income security of retirees who owe little or no taxes.

In attempting to resolve the compliance problem, the Associations believe an augmented voluntary approach ought to be pursued. This should include improved reporting and enforcement as well as requiring payors to notify retirees of their right to elect withholding. If the Committee decides to go this route, the Associations will do whatever is possible to inform our members about the taxable nature of pension distributions as well as the choice that needs to be made for those who owe taxes between withholding and paying estimated taxes. Much of the compliance problem could be resolved if current practices are tightened up.

If the Committee finds that the withholding approach adopted by the bills before it is absolutely essential, the overwithholding defects must be addressed. Certainly, exempting small periodic pensions from automatic withholding is clearly called for. Persons with relatively small pensions who are not likely to have any federal income tax liability should not be faced with the burden of having to "elect out" of automatic withholding.

The Associations believe that the withholding provisions of H.R. 5829 and H.R. 6300 present unacceptable risks to many vulnerable retirees who rely on their pension benefit to meet the day-to-day cost of living. Given this consideration, we must oppose the automatic withholding sections of the bills before the Committee. However, we hope we can continue to work with the Committee and other interested parties in the effort to lessen whatever tax compliance problem may exist without creating hardship for those who do not owe taxes.

Another item in H.R. 6300 would be useful to people planning for retirement. Under Section 312 of H.R. 6300 a partial rollover of an Individual Retirement Account distribution could be made tax-free. Current law allows tax-free IRA rollovers only if the entire amount is transferred. Because this Section provides for greater flexibility in retirement planning, the Associations believe it should be included in the Committee's final legislative package.

Mr. GUARINI. Thank you, Mr. Hacking.

The next witness will be Mr. George Cowles of the Association of Private Pension and Welfare plans.

STATEMENT OF GEORGE W. COWLES, SENIOR VICE PRESIDENT, BANKERS TRUST CO., ON BEHALF OF ASSOCIATION OF PRIVATE PENSION & WELFARE PLANS; ACCOMPANIED BY THEODORE RHODES, COUNSEL

Mr. COWLES. My name is George W. Cowles. I am a senior vice president of Bankers Trust Co. in New York. I am testifying today on behalf of the Association of Private Pension & Welfare Plans. I am accompanied by Theodore Rhodes, counsel to the association. I appreciate the opportunity to testify regarding the Taxpayer Compliance Act of 1982, recently introduced by Congressman Rostenkowski, and the Taxpayer Compliance Improvement Act of 1982, introduced earlier in this Congress by Congressman Conable and Senator Dole.

Our over 600 member firms represent the full spectrum of employers, plan sponsors, and professionals involved with the administration of every type of private pension and welfare plan being maintained in America today. Many of our members are payors of pension benefits and consequently will have the responsibility to carry out the administratively burdensome withholding requirements of the bills.

In fact, the employee benefit division of Bankers Trust Co., which is my area of responsibility, makes 125,000 pension payments each month. In addition, we make 350,000 partial distributions each year and 180,000 lump-sum distributions each year.

The Association recognizes the need to improve compliance with the income tax law, and we heartily endorse constructive efforts to obtain better compliance. There is one provision in these bills, however, that we strongly oppose, and that is the provision which would establish a mandatory system of withholding on annuities and other plan distributions. Under current law, a pension payment from a qualified plan is not subject to withholding unless the employee elects to have it so treated. The provision introduced in the subject bills would reverse the current law so that a pension payment is automatically subject to withholding unless the employee elects not to have it so treated.

Our association believes that a program of automatic withholding on annuities and other plan distributions creates substantial short- and long-term problems for payors and recipients. First, there is the substantial startup cost associated with the implementation of the program. The startup cost and the cost of continued maintenance of the system will ultimately be borne by the plan funds and may, in the long term, cause pension benefits to be reduced.

Second, there is the problem of communicating the automatic withholding system to the recipients. This would be an extremely difficult task and burdensome for all parties, especially those who currently receive pensions from which income taxes are not withheld.

Finally, the automatic system would inevitably result in hardship to recipients because of the likelihood of overwithholding.

For these reasons, we oppose the automatic withholding provisions of the subject bills. We believe that instead of automatic withholding, the compliance problem, assuming there actually is one, can be solved by making the present system work.

Under current law, payers of pension benefits are already required to furnish a "Statement for Recipients of Periodic Annuities, Pensions, Retired Pay, or IRA Payments"—form W-2P—indicating the amount paid to the annuitant during the year under the terms of the plan. Moreover, the IRS now receives a statement of "Total Distributions From Profit-Sharing Retirement Plans and Individual Retirement Arrangements"—form 1099-R—covering each lump-sum payment.

The association believes that these forms already include the information necessary for the IRS to enforce the payment of taxes by recipients of benefit payments from qualified employee benefit plans.

My bank files over 6,000 such forms each year. If the information on these forms is useless to the Internal Revenue Service, I would suggest that payors stop being asked to prepare the forms, which cost several thousand dollars a year to prepare.

Because of the tremendous hardships which may be created by an automatic withholding system, we believe we owe it to the public to try to make the current system work before making any radical changes in it.

If, however, Congress decides to proceed with the adoption of an automatic withholding system, we would like to assist the committee in developing changes to the proposals which would minimize the burdens it would impose on the concerned parties. In this regard, we agree with the suggestions of other panelists for improvements to the bill.

If I may digress for a moment and respond to Congressman Moore's question, my bank is marketing a version of an IRA product. My reaction is that the 10-percent penalty currently in the law is a deterrent against withdrawal. We do feel, however, that a 15-percent tax penalty would very likely become a deterrent to establishing IRA accounts in the first place, particularly among those with a middle income and younger potential clients.

Thank you, Mr. Chairman.

Mr. GUARINI. I thank you, sir.

Mr. Jerry Oppenheimer and Mr. Adrian Collins, representing the ERISA Industry Committee.

STATEMENT OF ADRIAN COLLINS, EXXON CORP., ON BEHALF OF ERISA INDUSTRY COMMITTEE, ACCOMPANIED BY JERRY L. OPPENHEIMER, COUNSEL

Mr. COLLINS. Thank you. I am Adrian Collins of Exxon Corp. I appear today on behalf of the ERISA Industry Committee, known as ERIC, an organization of some 100 major companies which maintain retirement plans for their employees. I am accompanied by Jerry L. Oppenheimer, a member of the firm of Mayer, Brown Platt, counsel to ERIC.

Mr. Chairman, the growth of the income tax compliance gap is a serious national problem which affects all taxpayers. Accordingly, ERIC strongly supports properly balanced proposals to resolve this problem. The text of the chairman's bill, H.R. 6300, was not available, as you know, until very late last week, and we have not had an opportunity to review it carefully.

Accordingly, our comments today are necessarily general, and, with your approval, we will file a more complete statement for the record by the end of the week.

ERIC is concerned that the proposed withholding on pensions and other retirement income in the parallel bills introduced by Mr. Conable and Senator Dole, H.R 5829 and S. 2198, would impose unintended but significant burdens on the elderly and increase administrative costs which in many cases would be borne by the retirees.

The chairman's bill may be an improvement over the Dole-Conable bill, but it does not completely overcome these basic concerns. A more promising solution would be improved use by the Internal Revenue Service of the information presently submitted to it by payors of retirement income.

Before any new system is adopted, specific estimates of the revenue to be derived from it should be obtained. If a new withholding system is to be adopted, we want to work with the committee to assure that the system is fair, workable, and cost effective.

In this regard, we disagree with Mr. Chapotan's suggestion made earlier today that the costs of administering the proposed withholding system would be no greater than that of administering the present voluntary system. On the one hand, under the present voluntary withholding system, an accountant may request that a specific dollar amount be withheld. On the other, in the proposed provision, a graduated payroll table must be programed into any annuitant payroll system.

Some of our preliminary thoughts in this regard include:

First, the system might be phased in with respect to new retirees in order to avoid the difficulties of dealing with present retirees, some of whom are of considerably advanced age.

Second, overwithholding might be diminished by excluding from the system all periodic payments below an appropriate amount; for instance, on an annual basis, the amount of income which could be received tax-free by a retiree and a spouse if both were over age 65.

Third, administrative costs and difficulties for the elderly might be reduced by minimizing elections; for instance, the system might be made mandatory with respect to periodic payments above an appropriate amount and any elections might remain effective until changed.

Fourth, administrative costs and difficulties for the elderly might also be reduced by requiring withholding on periodic payments at a flat rate rather than treating the payments as wages subject to a progressive rate.

Finally, Mr. Chairman, the effective date for any new system must give us adequate lead time for implementation. An unduly prompt effective date would lead to massive noncompliance and chaos for the service, payors, and retirees. I have in mind something like a 9-month period which would give the Internal Revenue Service and the Treasury 3 months to get regulations out, give employers and administrators 3 months to communicate with retirees, and implement a program, and another 3 months for the retirees to get back to us and for us to put their responses into the system.

I will be happy to expand upon these ideas and to respond to questions if time permits. Thank you, Mr. Chairman.

[A statement follows:]

SUPPLEMENTARY STATEMENT OF THE ERISA INDUSTRY COMMITTEE (ERIC)

This statement deals only with the proposals to establish a new system of withholding on deferred income and related reporting requirements. It is submitted on behalf of the ERISA Industry Committee (ERIC), an organization of some one hundred major employers which maintain employee benefit plans for the benefit of their employees, and supplements the ERIC testimony of May 18, 1982.

Summary of position

The growth of the income tax compliance gap is a serious national problem which affects all taxpayers. Accordingly, ERIC strongly supports properly balanced proposals to close the compliance gap.

ERIC supports the important proposals to improve the operation of information reporting systems and to enhance the Service's enforcement capabilities. These measures would increase taxpayer compliance without creating excessive new paperwork burdens. More specifically, ERIC supports the proposals to permit the Treasury to require reports on magnetic tape or in other machine readable form, but only if the affected party already has the capacity so to report. ERIC would also support reasonable improvements in the content of existing reports from payors of deferred income, if adequate lead time for compliance were permitted.

ERIC opposes the proposed withholding on partial or total distributions from qualified plans because it would impose harsh burdens on the elderly and increase administrative costs which in many cases would be borne by retirees.[1] More promising solutions for underreporting of deferred income are (1) more effective education of retirees and soon-to-be retirees regarding the taxable nature of their distributions, their present ability to elect withholding on annuity distributions, and their obligation to file estimated returns and (2) improved use by the Service of the information submitted by payors.

Payors of retirement benefits are presently required to file information returns on Forms W-2P and 1099R. The compliance gap arises importantly from the Service's inability to process the presently required information effectively, not from payor's failures to report. If retirees know that the Service will take action if they fail to pay estimated taxes, elect voluntary withholding, and/or report their distributions on their returns, compliance should improve. If the current reporting and enforcement system worked as intended, the compliance problem would be greatly diminished. Thus, ERIC strongly supports funding the Service's enforcement efforts at a more appropriate level.

The compliance problem with deferred income should be addressed in the same manner as that for dividends, interest, and capital gains, that is, through reports from payors to the Service and improvement of the Service's use of those reports, rather than by automatic withholding. There is no reason why retirees should bear a greater burden than recipients of dividends, interest, or capital gains, or why payors of retirement benefits should be put to any greater burden than other payors.[2]

If, notwithstanding the arguments against adopting a new withholding system, one is to be adopted, the Committee must assure that the system is fair, workable, and cost effective. Before any new system of withholding is adopted, specific estimates of the revenue to be derived from it should be obtained. In this context, the Committee should consider the following:

(1) In order to avoid the difficulties of dealing with present retirees, any new withholding system might be phased in to apply only with respect to new retirees.

(2) In order to avoid over withholding and unnecessary and confusing notices to retirees, all payments less than an appropriate amount (e.g., on an annual basis, the maximum amount of income which could be received tax-free by a retiree and spouse if both were over age 65) should be exempt from any new withholding requirement.

(3) In order to avoid the difficulties associated with elections, the amount by which payments exceed the appropriate exempt amount might be subject to mandatory withholding.

---

[1] Estimates of compliance costs depend upon such factors as the number of plans sponsored by the same employer, the number of recipients, plan size, the sophistication of present systems, and existing computer capabilities. Thus, preliminary and incomplete estimates vary greatly. The highest exceeds $400,000 for start-up costs and $100,000 per year thereafter. These costs would be approximately the same under either the "Taxpayer Compliance Improvement Act of 1982" (H.R. 5829) or the "Tax Complaince Act of 1982" (H.R. 6300).

[2] Commissioner Egger's May 18 statement before this Committee estimated that the unpaid tax on deferred income was $2.8 billion in 1981. This is less than one-third of the estimated unpaid tax on capital gain income and less than the estimated unpaid tax on either dividends or interest. It is approximately the same as that on wages, on which there is mandatory withholding. It is less than five percent of the total unpaid tax on individual legal sector income for 1981. It is important to note, however, that these estimates are not estimates of the revenue which would be raised by the proposals in question. Such estimates have not been made available by the Treasury or Congressional staff, but they were promised by Assistant Secretary Chapoton.

(4) In order to avoid dealing with Forms W-4 and related problems, withholding on payments in excess of the exempt amount might be at an appropriate flat rate (e.g., ten percent) rather than treating the payments as wages.

In the absence of revenue estimates and a cost/benefit analysis, the Committee cannot be sure that the costs of withholding will not be disporportionate to any incremental collections by the Treasury. Before taking action on any proposal, the Committee should require specific revenue estimates and cost-benefit analyses to determine if other less burdensome measures would be more appropriate to resolve the compliance gap. Improved use of information currently provided to the Service by payors and encouragement of voluntary withholding by retirees are more promising solutions.

In any event, the effective date for any new reporting or withholding system must give adequate lead time for implementation. An unduly prompt effective date would lead to massive noncompliance and chaos for the Service, payors, and retirees.

SUBJECT TO APPROPRIATE LIMITATIONS, ERIC GENERALLY SUPPORTS REQUIRING ADDITIONAL REPORTS TO THE SERVICE, PARTICIPANTS, AND BENEFICIARIES

Both the "Taxpayer Compliance Improvement Act of 1982" (H.R. 5829) and the "Tax Compliance Act of 1982" (H.R. 6300) would provide specific regulatory authority to require the employer or plan administrator to make returns and reports to the Service, participants, beneficiaries, and other persons.[3] The contents of such reports are not described in the bills, but Assistant Secretary Chapoton's testimony before the Committee suggested that the present information reporting system may not always result in participants and beneficiaries receiving all of the information necessary to determine the tax treatment of distributions.

ERIC believes that, if recipients of retirement benefits understand that a portion or all of their distributions may be subject to tax, most will comply with the tax law. Either they will request withholding under present law at an appropriate level, taking into account their other income, deductions, and exemptions, or they will make estimated tax payments. Most of those who fail to report retirement income properly do so through a misunderstanding of the taxable nature of such distributions; relatively few may believe that the Service does not effectively enforce existing law. Thus, improvements in reporting may well obviate the need for automatic withholding.

In any event, the withholding proposals would not solve any perceived problem of intentional noncompliance. Those relatively few retirees who may now intentionally avoid their tax liability could continue to do so under either bill by electing out of withholding.

As noted by Mr. Chapoton, however, employers and plan administrators now generally provide recipients with information regarding the tax treatment of distributions, although there is no requirement either that they do so or that they report the information to the Service. If the content, form, and timing of the proposed reporting requirements are not overly burdensome,[4] ERIC would generally support reporting to the Service and to employees and beneficiaries information which is routinely available to plan administrators and which is reasonably necessary for determining the tax treatment of any distribution.

In any event, ERIC urges that the Treasury's authority to prescribe regulations should be carefully circumscribed to avoid the overly burdensome reporting requirements which have been too common in other areas involving qualified plans. Furthermore, particular care must be taken to assure adequate lead time for plan administrators and employers to revise existing information collection and reporting systems.

---

[3] We are concerned that payors of deferred income might also be required to file information returns under the proposal in H.R. 6300 regarding payments to non-employees. Payments to retirees are for services previously performed, but the proposed exception for wages paid employees would not apply. It should be clarified that any amount subject to the proposed reports for deferred income would be treated the same as payments to active employees and would not be subject to the proposed reports for non-employee payments.

[4] For example, ERIC is concerned that, as proposed, duplicate reports might be required with respect to a single distribution, adding to the payor's costs and the recipient's confusion. Forms W-2P and 1099R are now required of the payor to report the amounts of periodic and non-periodic distributions to both the Service and the recipients. These forms could be revised to include information regarding the tax treatment of the distributions. If so, no separate reports should be required from plan administrators. A separate report would result in additional paperwork, additional expense for preparation and filing, and another report for the Service to process and "match" to the recipient's return. In addition, the recipient might be confused by two reports and report the distribution twice on his tax return. If, instead of revised Forms W-2P and 1099R, the intent is to require new reports from plan administrators (which is what both bills would seem to require) the requirements that the payors file Forms W-2P or 1099R should be eliminated. In short, new reporting requirements must be implemented only after careful consideration.

In this connection, we note that H.R. 6300 would provide a new penalty for failure to develop and maintain records necessary to comply with its proposed reporting requirements. Mr. Chapoton's testimony questioned the need for the new penalty, and ERIC strongly urges that it be deleted. The intended application of the proposed penalty is unclear, but in no event should any penalty apply in any case where reasonable efforts have been taken to establish and maintain appropriate records.

ERIC OPPOSES THE WITHHOLDING PROPOSALS

Under both bills, withholding would be required for annuity and other periodic payments from a qualified plan, unless the recipient elected not to have withholding apply. Under H.R. 6300, notices of election rights would be required within a ninety day period beginning thirty days before payments commence, and no withholding would be required prior to the third month after payments commence. Under H.R. 5829, regulations would prescribe the time and manner of providing notices and making elections, and elections would have to be renewed annually. Under both bills, an annual notice would have to be given to each recipient of his or her right to make or change an election. Similarly, under both bills, the amount withheld would be determined as if the taxable amount of the distribution were wages.

The treatment of other distributions would vary between the bills, but both would also require withholding on total distributions (generally referred to as "lump sum distributions"). Under H.R. 5829, the former employee could elect "out" only by certifying that he intended to "roll over" the distribution to an IRA in a tax-free transaction. Under H.R. 6300, the right to elect "out" would apply to each non-periodic distribution, and the payor would generally have to give the recipient notice of that right.

H.R. 5829 contemplates that withholding tables would be published which would assume that the entire taxable amount of a lump sum distribution would be treated as ordinary income which would qualify for special ten-year averaging. H.R. 6300 would require the development of tables to reflect that a lump sum distribution may qualify in part for such treatment and in part for capital gain treatment.

Under H.R. 5829, non-periodic distributions, other than total distributions, would be treated as wages. Under H.R. 6300, withholding on non-periodic, but non-total, distributions would be at a flat ten percent rate.

Under both bills, the amount withheld could not exceed the sum of money and the fair market value of other property (excluding employer securities) received in the distribution in the case of both periodic and non-periodic payments. Both proposals would generally be effective for distributions made after December 31, 1982.

In general, the provisions of H.R. 6300 are an improvement over those of H.R. 5829, but both bills would cause significant hardship for retirees, who are particularly ill-equipped to deal with them, would add significantly to the cost of administering plans, and could cause many plans, particularly defined contribution plans, to eliminate further periodic or annuity forms of distributions.

A. *The notice and election procedures for periodic distributions would be unduly costly and confusing to the elderly*

Under current law, recipients of annuity benefits may request withholding from the payor. No tables are prescribed, and the recipient may request whatever level of withholding is appropriate to his individual circumstances. The essential difference between existing law and the withholding proposals of both bills is to place upon retirees the burden to elect "out" of, rather than to allow them a continuing option to elect "in" to, the withholding system.

ERIC submits that the proposals would place harsh and unnecessary burdens on both plan administrators and retirees. Under either proposal, before any withholding could be implemented, the payor would have to obtain, from each retiree, either a Form W-4 setting forth his withholding exemptions or an election "out" of withholding. It would be impossible to obtain responses from all retirees and difficult and expensive to obtain them from most retirees.

Retirees are widely scattered, and, accordingly, the printing and postage costs alone would be significant. Processing required Forms W-4, elections, and notices would be far more expensive than administering the present system. Procedures and computer programs would have to be revised to take into account changes in the withholding tables applicable, from time to time, to wages. Indeed, the cost of complying with an automatic withholding system with annual notice or election procedures in may cases would exceed the amount of tax withheld.[5] These costs would eventually fall principally on retirees because increased administrative costs mean fewer dollars available to pay benefits.

Requests for Forms W-4 or elections would frequently be lost, mislaid, and, in many cases, never received or received too late to afford a timely response. For example, many pensions are paid directly to a bank or other financial institution for credit to the retirees' accounts, and the payor has no idea where the retirees may be located.

More significantly, and too often, notices would be misunderstood by retirees. Many retirees are not sophisticated. Many are aged[6] or infirm. They may be in nursing homes; they may be senile; they may be impaired in hearing or eye sight. Many of these retirees cannot be expected to understand or to make a rational response to a payor's notice. How does one effectively explain to an elderly person that his or retirement check will be reduced if a Form W-4 or an election form is not promptly and properly returned? Retirees with more than one pension would receive multiple notices, adding to their confusion. Similarly, there would be multiple notices with which to contend if both spouses received pensions. In sum retirees would find dealing with the proposed system to be confusing and unsettling.

ERISA requires that retirees be sent summary plan descriptions (SPDs) and summary annual reports (SARs). These requirements, though well intended, and these documents, though carefully drafted, are confusing and unsettling to many retirees. Whenever SPDs or SARs are provided, it is unfortunate, but inevitable, that the only reaction of significant numbers of retirees is "does this mean I will lose my pension?". It is likely that many retirees would find the payor's request for a Form W-4 or election "out" of withholding even more confusing, unsettling, or fearsome. Even for plan administrators with the best systems, forms would not be returned, and retirees would suffer.

B. Annual notices or elections regarding periodic distributions would be particularly confusing and are not necessary

The requirement in H.R. 5829 that an affirmative election "out" of withholding be made each year would exacerbate these problems. It wias appropriately opposed by Mr. Chapoton as imposing undue burdens on retirees and on plan administrators. Retirees who understood the original notice and made an election might well not continue to understand that they would be required to make a new election each succeeding year for the rest of their lives.

Even H.R. 6300, which contemplates that an election would be binding until revoked, would require an annual notice of the right to make or revoke an election. Many retirees who had made an election or filed a Form W-4 after the first notice would be disturbed and confused by these repeated notices, even though they would require no action by the retiree. The payor would have to spend significant time each year attempting to explain to retirees both the purpose of any notice or election and its effects. These additional costs are unnecessary and would, eventually, adversely impact retirees' beneftis.

No annual notification or election is required for withholding from wages; an employee claims only once his exemption and extra or reduced allowances, and his directions are followed until changed. Similarly, under the current voluntary withholding system, an annuity recipient may elect withholding and the election is followed until modified, without any reminders from the payor of the recipient's right to modify or revoke the election.

C. Over withholding and interest-free loans to the Government would be unfair to the elderly

The proposed withholding might well result in significant over withholding, and the major effect might be the elderly's deprivation of a portion of their pensions. This could have a significant adverse effect on those elderly who are not well-to-do. The Committee should not adopt any withholding system that risks taking advantage of those who are frequently infirm, uneducated, or otherwise unable to cope with the system.

Under both bills, notices regarding withholding from periodic retirement benefits would be received by many who have no tax liability and correctly file no income tax returns. Retirees frequently qualify for additional exemptions for the aged and/

---

[5] Withholding at an appropriate flat rate (such as ten percent) would lessen the cost for many payors who do not currently have the capacity to process Forms W-4 and implement wage-based withholding.

[6] One plan sponsor has volunteered that twenty percent of its annuity recipients are over age 80.

or the tax credit for the elderly. Failure to elect "out" of automatic withholding would require retirees to file claims for refunds. Many would not, thus creating an unfair windfall for the Treasury, and those who did obtain refunds would have made unfair interest-free loans to the government. Only a few very sophisticated retirees would have the ability and knowledge to adjust their estimated tax payments on other sources of income to avoid such interest-free loans to the Treasury.

One of the frequent criticisms of the current requirement that retirees file estimated taxes is that few understand the system. Fewer still can be expected to understand or cope satisfactorily with the automatic withholding proposals and their requirements for filing Forms W–4 and elections. Retirees would be further confused and distressed by the annual notices, whether reminders of election rights under H.R. 6300 or election forms under H.R. 5829. Many would simply ignore all of the notices; their pensions would be reduced without regard to any withholding exemptions to which they would be entitled; they would not file claims for refunds; their standard of living, already frequently unacceptably low, could be adversely affected; and they would be resentful of the government and their former employers.

If the proposed system worked as intended, many recipients would file a Form W–4, and nothing would be withheld from their pensions. It would be wasteful to require recipients to file a Form W–4 or an election if withholding from their benefits would be required only when they failed to respond to the payors' notices. Nothing could justify either the payors' costs of obtaining and processing such forms and elections or the distress the notices would cause the elderly. Accordingly, if, notwithstanding the arguments against any new system, one is to be adopted, payments less than an appropriate amount (e.g., on an annual basis, the maximum amount of income which could be received tax-free by a retiree and spouse if both were over age 65) should be exempt from any new withholding or notice requirement.

D. The proposals could cause elimination of some periodic forms of retirement benefits

Enactment of either of the proposals could also lead to the elimination by some employers of periodic forms of benefit payments. ERIC is concerned that ERISA's imposition of the joint and survivor annuity requirements on defined contribution plans resulted in many plans eliminating optional annuity forms of benefit payments in favor of lump sum or fixed term distributions. The administrative costs associated with automatic withholding and either the annual notice or annual election procedures could further discourage employers, particularly smaller employers, from offering periodic forms of distributions. If lump sum distributions became the predominant form of benefit, many employees and their beneficiaries would suffer because of premature dissipation of the distribution.

E. Withholding requirements with respect to non-periodic distributions could cause additional hardship

The proposals treat total distributions (generally known as "lump sum distributions") differently. Under H.R. 5829, the recipient of a lump sum distribution would not be permitted to request withholding at a lesser amount, as is currently the case for annuity distributions. The recipient could waive withholding only by certifying that the distribution would be "rolled over" to an individual retirement account (IRA). While there are indications that the Service's tables would take into account the lower tax rate applicable to any capital gain portion of a distribution, the bill would require withholding as if the entire distribution qualified only for ten-year averaging. Thus, an employee who received a lump sum distribution during the year would have to wait until his tax return was filed after the end of the year to claim any refund to which he might be entitled. The result could be a compulsory interest-free loan to the Treasury.

Under H.R. 6300, tables would be promulgated which would reflect both ten-year averaging and capital gain rules, and the recipient would be able to elect "out" for any reason. This is preferable to the proposal in H.R. 5829. Under H.R. 6300, the recipient would not be required to decide whether to roll over a distribution to an IRA before the distribution is received. However, the payor would be required to furnish the recipient a notice of his right to elect "out" of withholding. The Joint Committee staff explanation indicates that such notices would be required more than ninety but not less than thirty days prior to the distribution. In some cases, this could slow retirees' receipts of benefits since some payors process requests for non-periodic distributions in less than thirty days.

H.R. 6300 would subject other non-periodic distributions to withholding at a flat ten percent rate. H.R. 5829 would treat such distributions as wages. Either proposal might result in withholding in excess of the tax due on the distribution.

F. All in kind distributions should be exempt from withholding

In the case of many individual account plans, the employee is allowed to direct his own investments in one or several investment media. Frequently, these plans provide for distributions in kind. Given adequate time [7] and employee sophistication, the liquidations of assets to satisfy the required withholding might be arranged to meet an employee's desires. Such arrangements would, however, also increase administrative costs. If an employee made no designation, the plan administrator would have to decide which of the employee's investments to liquidate in order to have cash available to satisfy the required withholding.

The bill provides an exception for distributions of employer securities, which is very important especially in the case of ESOP or TRASOP plans which invest principally or solely in employer securities. A similar exception should be provided for all in kind distributions from individual account plans.

THE EFFECTIVE DATE FOR ANY NEW REQUIREMENTS SHOULD AFFORD ADEQUATE LEAD TIME FOR IMPLEMENTATION

Commissioner Egger, in his testimony before the Committee, noted the wide-ranging potential impact of the bill on the data processing systems of both the private sector and the Service and urged that adequate lead time be provided to implement any new requirements. H.R. 5829 would require withholding on all payments made after December 31, 1982. H.R. 6300 would be generally effective on the same date, but withholding on periodic payments could be delayed three months. As a practical matter, plan administrators, other payors, and the Service would be unable to comply with the effective date proposed in either bill.

It is unlikely that any bill will be enacted before June 30. Once enacted, the Service would have to publish withholding tables, and regulations would have to be issued regarding the notice and election procedures and other matters. Mr. Chapoton advised the Committee that it would take "several months" for necessary guidance to be published. Thus, the Treasury and the Service are not likely to provide all necessary regulations, procedures, and forms before January 1, 1983.

Only then could the process of adopting procedures and modifying computer programs begin. As recognized by Mr. Chapoton, this could also be expected to take several months. Another six months might be necessary (or until June 30, 1983).

Once everything was in place, notices to retirees would be sent out, and responses would be processed when returned, including Forms W-4 from those who did not elect "out". Under H.R. 6300, a recipient would generally have ninety days from the time of mailing to respond to a notice. It is unlikely that many retirees would return an election form or a Form W-4 immediately, and payors would need at least thirty days to implement retirees' decisions once received. Many payors would be fortunate to process all responses within thirty days after receipt. Thus, a minimum of four or five months would be needed for the initial notification, election, and implementation procedures (or until October or November, 1983).

Even these estimates may be unrealistically optimistic. They depend on the Service issuing final and complete guidance by January 1, 1983, and all plan administrators, large and small, being able to implement the Service's guidance within six months. This assumes that all plan administrators act promptly and can devote what would be significant time and resources to the effort. There would be a tremendous demand for assistance from computer programers and others who are in short supply and who could not respond simultaneously to all demands. Hasty implementation to meet unreasonably short deadlines would result in massive noncompliance and chaos for payors, retirees, and the Service.

Accordingly, to permit a more orderly and mistake-free process, if, notwithstanding the arguments against any new withholding proposals, any are to be adopted, it would be appropriate to provide that no withholding be required until the later of January 1, 1984, or twelve months after the Treasury issues final regulations to implement any new withholding requirements.[8]

---

[7] Adequate lead time might be impossible to provide. For example, one plan which makes over 100,000 in kind distributions at the end of each year begins processing stock transfers 6 to 8 weeks before the distributions occur. Price changes in the interim would affect the amount of withholding required, the employees' investment returns, and which securities to liquidate.

[8] Another consideration is coordinating withholding with estimated tax obligations. It would be easier for retirees to understand and for the Service to administer if any new withholding requirement commenced with a calendar year. As recognized by Mr. Chapoton, payments made between the date of the notice and the commencement of withholding might give rise to estimated tax penalties.

Similar problems with the development of regulations and redesigning systems would be encountered in implementing any new reporting requirements, and there must be adequate lead time for compliance. This is partially recognized in H.R. 6300 by proposing to delay certain new recordkeeping penalties until January 1, 1985, although the proposed reporting requirements would be effective on January 1, 1983. To allow orderly implementation, any enhanced reporting requirements should not become effective until the later of Jaunary 1, 1984, or twelve months after the Treasury issues final regulations defining any new reporting and recordkeeping requirements.

Mr. GUARINI. Thank you, Mr. Collins.

Mr. Conable.

Mr. CONABLE. I have no questions. I will just say that Mr. Collins is very optimistic if he thinks that Treasury can get regulations out in 3 months. Sometimes it takes more like 6 years to get regulations out.

Mr. COLLINS. We always have hope.

Mr. CONABLE. I thank you for your suggestions, gentlemen. This is a terribly complex area, and obviously an area of considerable concern to people who have not enjoyed living with the degree of regulation that they have had to live with already. We will do the best we can. Thank you.

Mr. COLLINS. Thank you, sir.

Mr. GUARINI. Mr. Vander Jagt.

[No response.]

Mr. GUARINI. Thank you for your patience, gentlemen, and for being here all day and giving us your thoughts and recommendations. Now we will excuse the panel, and I think that will close the day. There are no further panels to be heard, and we will close the record until further instructions from the Chair.

Thank you.

[Whereupon, at 2:45 p.m., the hearing was adjourned.]

[Material submitted for the record follows:]

MAJORITY MEMBERS
JACK BROOKS, TEX., CHAIRMAN
L. H. FOUNTAIN, N.C.
DANTE B. FASCELL, FLA.
BENJAMIN S. ROSENTHAL, N.Y.
DON FUQUA, FLA.
JOHN CONYERS, JR., MICH.
CARDISS COLLINS, ILL.
JOHN L. BURTON, CALIF.
GLENN ENGLISH, OKLA.
ELLIOTT H. LEVITAS, GA.
DAVID W. EVANS, IND.
TOBY MOFFETT, CONN.
HENRY A. WAXMAN, CALIF.
FLOYD J. FITHIAN, IND.
TED WEISS, N.Y.
MICHAEL L. SYNAR, OKLA.
EUGENE V. ATKINSON, PA.
STEPHEN L. NEAL, N.C.
DOUG BARNARD, JR., GA.
PETER A. PEYSER, N.Y.
BARNEY FRANK, MASS.
HAROLD WASHINGTON, ILL.
TOM LANTOS, CALIF.
BARBARA B. KENNELLY, CONN.

NINETY-SEVENTH CONGRESS
Congress of the United States
House of Representatives
COMMITTEE ON GOVERNMENT OPERATIONS
2157 Rayburn House Office Building
Washington, D.C. 20515

MINORITY MEMBERS
FRANK HORTON, N.Y.
JOHN N. ERLENBORN, ILL.
CLARENCE J. BROWN, OHIO
PAUL N. MC CLOSKEY, JR., CALIF.
THOMAS N. KINDNESS, OHIO
ROBERT S. WALKER, PA.
M. CALDWELL BUTLER, VA.
LYLE WILLIAMS, OHIO
JOEL DECKARD, IND.
WILLIAM F. CLINGER, JR., PA.
RAYMOND J. MC GRATH, N.Y.
HAL DAUB, NEBR.
JOHN HILER, IND.
WENDELL BAILEY, MO.
LAWRENCE J. DE NARDIS, CONN.
JUDD GREGG, N.H.
MICHAEL G. OXLEY, OHIO

MAJORITY—225-5051
MINORITY—225-5074

May 18, 1982

COMMITTEE ON
RECEIVED
MAY 19 1982
WAYS AND MEANS

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Like many members of Congress, I am very interested in the tax compliance acts (H.R. 6300 and H.R. 5829) that are presently pending before the Ways and Means Committee. In reviewing both bills, I am pleased that steps are being taken to assure that those who abuse our tax system at the expense of honest, taxpaying citizens are hopefully going to find it harder to persist in their aberrant behavior in the future.

As you may recall, the Committee on Government Operations' Subcommittee on Commerce, Consumer, and Monetary Affairs, chaired by Benjamin S. Rosenthal, held hearings this past June on the IRS Response to the Illegal Tax Protester Movement. During these hearings it was noted that one of the fastest growing forms of tax protest involved the filing of false W-4 withholding statements. This is a particularly egregious form of tax abuse as it places innocent employers in the precarious position of facing legal action by the IRS if they don't withhold taxes from wages and facing legal action from employees if they do withhold taxes from wages.

Right now in the 9th District of Texas, increasing numbers of employers are being placed in this "Catch-22" situation as the number of W-4 tax protesters grows. Although the problems posed by the W-4 tax protesters is particularly acute in my District, Southeast Texas is by no means the only region in the nation where increasing numbers of people are giving their employers false W-4 withholding forms in an effort to avoid paying taxes. It is my understanding that in FY 1981 a total of 400,000 employees were found to have filed false W-4 forms and in just the first quarter of FY 1982 close to 200,000 employees were found to have done the same. According to the IRS, "Form W-4 abuse has the potential for explosive growth if present trends continue unchecked."

In this tax protest scheme, employees claim excessive withholding allowances or complete exemption from withholding so that little or no Federal income taxes are withheld from their earnings by their employers. By depriving the government of their tax funds during the year, W-4 abusers are enjoying economic benefits at the expense of those who pay their taxes in installments throughout the year. The IRS estimates that during FY 1981 W-4 abusers deprived the Federal Government of $577 million of funds which the government had to borrow at the cost of approximately $67 million. For FY 1983 the IRS estimates that these figures will be $1.1 billion and $127 million, respectively. During the recent hearings held by a Committee on Government Operations Subcommittee, the Commissioner of IRS stated that the W-4 abuse "situation represents an erosion in compliance which, if permitted to continue, threatens not only the withholding system but also the reporting and collection of taxes."

A little over a year and a half ago, the IRS established the Questionable Form W-4 Program in an attempt to stem the growing numbers of withholding abusers. In this program, the IRS describes questionable W-4 withholding forms and requires employers to send to the Service all such forms that their employees submit. The IRS then reviews these suspect W-4 forms and determines their validity. In 1981, 97 percent of all suspect forms were found to be invalid (i.e., false). In those cases where the employee's claimed exemption status is found to be false, the IRS directs the employer to disregard the employee's wishes and withhold taxes according to IRS instructions. In addition, the employer is instructed to disregard any subsequent W-4 withholding statements that such employees might submit in an effort to override the IRS directive. Failure to comply with the IRS instructions and withhold the specified amount from employees' wages places employers in violation of the tax laws.

At hearings held by the IRS in June 1981, several employers expressed concern that the Questionable From W-4 Program would subject them to "potential hostility by employees." Their fears were not unfounded for, to date, while no employer has defied IRS directions to withhold taxes from employees' wages, over 40 employers have been sued by their employees because the employer followed IRS withholding instructions. Thus far, all the suits have been dismissed in favor of the employer and in a half dozen instances employers have gone after and been awarded legal fees. In most cases, however, the employer has not been reimbursed for the legal fees incurred in implementing, under the threat of personal liability for failure to do so, the nation's tax laws.

The IRS appreciates the "Catch-22" situation faced by employers, for in 1979 an IRS study concluded that "legislation should be enacted to exonerate employers from all liability to employees or to impose an absolute bar of a lawsuit against the employer . . . with respect to the employer's compliance with . . . [IRS] regulations and/or directions of . . . [IRS] district directors," and "provide that if a suit against the employer is brought in the face of the statutory prohibition, the employer shall be awarded attorneys fees against the plaintiff."

In an effort to address the problem posed by W-4 tax protesters, I would like to request that consideration be given to incorporating the provisions of "The Employer Withholding Protection Tax Act of 1982" (copy attached) into any tax compliance measure reported out of the Ways and Means Committee.

The provisions of this Act would bar any law suit brought by an employee against an employer for the latter's compliance with IRS withholding instructions. In so doing, it also relieves the employer of all liability to employees for withholding taxes from wages pursuant to IRS directives.

Should an employee bring suit against his/her employer in violation of the above prohibition, this Act provides for reimbursement to the employer for any legal expenses he/she incurs as a result of the illegal action.

In addition, this Act strengthens the ability of the IRS to deal with W-4 abusers by explicitly authorizing the Service to impose a penalty on anyone who files a false W-4 form and by increasing the civil penalty the Service can assess for second and subsequent false W-4 filings from $500 to $1000. It also increases the criminal penalty for filing a false W-4 from $1000 to $1500. These changes are made for the purpose of putting all W-4 protesters on notice that continued efforts to harass employers and abuse the nation's tax system will be very costly.

I appreciate your attention to this matter and look forward to working with you in developing methods to enhance compliance with the nation's tax laws.

Sincerely,
Your friend
Jack Brooks

JACK BROOKS
Chairman

Enclosure

[TENTATIVE DISCUSSION DRAFT]
April 28, 1982

97TH CONGRESS
2D SESSION

H. R. ______

IN THE HOUSE OF REPRESENTATIVES

Mr. BROOKS introduced the following bill; which was referred to the Committee on ____________

A BILL

To amend the Internal Revenue Code of 1954 to prohibit certain suits against employers complying with withholding notices, to increase the penalties for filing false withholding statements, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the ''Employer Withholding Protection Tax Act of 1982''.

SEC. 2. PROHIBITION OF CERTAIN SUITS AGAINST EMPLOYERS COMPLYING WITH WITHHOLDING NOTICES; ATTORNEY'S FEES.

(a) IN GENERAL.--Subchapter B of chapter 76 of the Internal Revenue Code of 1954 (relating to proceedings by taxpayers and third parties) is amended by redesignating section 7430 as section 7431 and by inserting after section 7429 the following new section:

''SEC. 7430. PROHIBITION OF CERTAIN SUITS AGAINST EMPLOYERS COMPLYING WITH WITHHOLDING NOTICES; ATTORNEY'S FEES.

''(a) IN GENERAL.--If the Secretary issues an employer a written notice of--

''(1) the maximum number of withholding exemptions or allowances under section 3402(f), or

''(2) denial of exemption from withholding under section 3402(n),

which the employer is to apply to any employee of such employer, no cause of action may be raised in any court by any individual against such employer for complying with such notice.

''(b) ATTORNEY'S FEES.--If any cause of action described in subsection (a) is raised, the court shall, with respect to such cause of action, award costs, expenses, and attorney's fees to the employer.''

(b) CLERICAL AMENDMENT.--The table of sections for subchapter B of chapter 76 of the Internal Revenue Code of 1954 is amended by striking out the item relating to section 7430 and by inserting in lieu thereof the following:

''Sec. 7430. Prohibition of certain suits against employers complying with withholding notices; attorney's fees.
''Sec. 7431. Cross references.''

(c) EFFECTIVE DATE.--The amendments made by this section shall apply to causes of action raised after the date of the enactment of this Act.

SEC. 3. INCREASED CIVIL PENALTY FOR FILING MORE THAN 1 FALSE WITHHOLDING STATEMENT.

(a) IN GENERAL.--Subsection (a) of section 6682 of the Internal Revenue Code of 1954 (relating to civil penalty for false information with respect to withholding) is amended by striking out ''$500 for such statement'' and inserting in lieu thereof ''$500 for the first such statement made by such individual and $1,000 for each subsequent such statement made by such individual''.

(b) EFFECTIVE DATE.--The amendment made by subsection (a) shall apply to subsequent statements (within the meaning of section 6682(a), as amended by this section) made after the date of the enactment of this Act.

SEC. 4. INCREASED CRIMINAL PENALTY FOR FILING FALSE WITHHOLDING STATEMENTS AND FAILURE TO SUPPLY INFORMATION.

(a) IN GENERAL.--Section 7205 of the Internal Revenue Code of 1954 (relating to fraudulent withholding exemption certificate or failure to supply information) is amended by striking out ''$1,000'' and inserting in lieu thereof ''$1,500''.

(b) EFFECTIVE DATE.--The amendment made by subsection (a) shall apply to acts and failures to act after the date of the enactment of this Act.

SEC. 5. PENALTY FOR FILING FALSE WITHHOLDING STATEMENT MADE APPLICABLE TO THE FIRST WITHHOLDING STATEMENT FILED BY AN INDIVIDUAL.

(a) IN GENERAL.--Paragraph (1) of section 6682(a) of the Internal Revenue Code of 1954 (relating to civil penalty for false information with respect to withholding) is amended by striking out ''which results in a decrease in the amounts deducted and withheld under chapter 24''.

(b) EFFECTIVE DATE.--The amendment made by subsection (a) shall apply to acts and failures to act after the date of the enactment of this Act.

STATEMENT OF HON. FRANK HORTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. Chairman, the Committee has before it two long, highly technical bills which are designed to improve compliance with the internal revenue laws.

I don't purport to be an expert on the details of the tax statutes, and I don't intend to comment on them.

I have noticed, however, that one section of each of these bills does pertain to something which I know about—the reduction of the paperwork burden imposed by the Federal Government on the American people. It is that subject which I want to address here.

From 1975 to 1977, I was chairman of the Commission on Federal Paperwork. That Commission documented the enormity of the paperwork burden which the Government creates. We estimated that the dollars spent on paperwork could exceed some $100 billion annually—much of it necessary, but a great deal unnecessary. In hearing after hearing across the country, the Commission heard of people's anxiety, frustration, and anger over Federal paperwork and redtape.

The hearings also brought to our attention that over half of this burden is generated by the IRS. In a special report on the paperwork aspects of taxation, the Commission found that many schedules and instructions are unnecessarily detailed and complex, and often are written in a manner inappropriate for taxpayers who must comply with them. Difficulty in comprehending the schedules and instructions results in justifiable anger and frustration which in turn contributes to the problem of noncompliance with the tax laws.

After its exhaustive study of the paperwork problem, the Commission developed 770 specific recommendations to bring the government-wide problem of excessive paperwork under control. The most important of the recommendations was that a central management office be created to supervise the overall paperwork reduction effort. I was extremely gratified to see a bill which I sponsored to do just that—the Paperwork Reduction Act of 1908—become law a year and a half ago. It established an Office of Information and Regulatory Affairs within the Office of Management and Budget to serve as a central clearance point for information collection requests proposed by all Federal agencies, and to set information management policy for those organizations.

One of the major imporvements made by the Paperwork Reduction Act was bringing every single agency under OMB's forms clearance authority. Previously, agencies responsible for more than three-quarters of the paperwork burden—including the IRS—had been outside OMB's purview. When the bill was on the House floor, no one made any effort to amend it. The measure passed by a vote of 328 to 13 and received the support of both you, Mr. Chairman, and your ranking minority member.

In the year that OMB has had clearance authority over forms proposed by IRS, the Paperwork Reduction Act has had a noticeable effect. According to the Information Collection Budget of the United States Government for fiscal year 1982, the paperwork burden generated by IRS was cut in the last year by nearly 60 million hours, or nine percent.

With that background, I am very surprised to see that both section 215 of H.R. 6300 and section 202 of H.R. 5829 would exempt the Internal Revenue Service from the requirements of the Paperwork Reduction Act. If the legislation now pending were to pass without amendment, IRS would be the first and only agency exempt from this important initiative. In bills designed to improve compliance with the tax laws, paperwork reduction must be accorded high importance, because as forms become simpler with questions easy to understand, people will be more inclined to fill them out. Consequently, I can think of no reason to include this provision in the legislation.

I think also, Mr. Chairman, that it is important to consider the relationship between IRS and OMB with regard to paperwork reduction. IRS employees are experts in the intricacies of the tax law; they know how to design forms which are technically accurate. OMB staff, on the other hand, are generalists; they look at forms from the point of view of the recipient. Both perspectives are essential to proper development of information collection devices. The forms must be accurate, for sure—but they must also be as simple and understandable as possible. By removing IRS from OMB review, we would preserve one objective, but lose the other. The result would be that the IRS would return to old ways of doing business, with the consequence of increasing the paperwork burden on the American people.

To ensure that we don't end up with that result, I urge you to delete from your legislation the exemption for IRS from the Paperwork Reduction Act.

In closing I would like to note that my concern over this exemption is also shared by the Administration, the Chairman of the Government Operations Committee, Mr. Brooks, and every single member of the Senate Governmental Affairs Committee.

Statement of John Shattuck, National Legislative Director, and Wade J. Henderson, Legislative Counsel, American Civil Liberties Union

We are pleased, on behalf of the American Civil Liberities Union (ACLU), to submit this statement on H.R. 6300, the "Tax Compliance Act of 1982." The ACLU is a national, non-partisan organization of more than 250,000 members devoted to the protection of individual rights and liberties under the Constitution.

The privacy of taxpayer information is an issue of great importance to the ACLU. This organization has testified frequently in congressional and other hearings on the subject, including hearings of this committee when it was considering the Tax Reform Act of 1976. Most recently we testified in opposition to proposed amendments to the disclosure provisions of the 1976 Act. We noted at that time that the disclosure and summons provisions of the Tax Reform Act and general, related limitations on investigative authority were the product of grave concern, borne of extensive revelations of governmental abuse, for the privacy of tax records held by the Internal Revenue Service (IRS).

Because of the highly sensitive nature of taxpayer information and the extraordinary, coercive power of the IRS to obtain such information without subpoena, warrant or any showing of probable cause, there is a compelling justification to strictly scrutinize all provisions which would expand the IRS' already unmatched authority beyond the limits of current law.

One element of a reasonable standard by which to measure such provisions might include examining whether the proposed change is supported by empirical evidence documenting the unmet need of current law. Another element of the standard should undoubtedly include the degree of fundamental due process protection afforded the taxpayer under the proposed change. By these considerations alone, several provisions of H.R. 6300 should be reexamined and modified.

The "Tax Compliance Act of 1982" seeks the laudable goal of improving voluntary compliance with the nation's tax laws, and reducing the so-called "tax gap," i.e. the differential between the revenues duly owed the government and those collected. This is a matter of understandable priority in view of the national economy. However, several provisions of H.R. 6300 are problematic and go beyond their stated goal, particularly those which purport to strengthen IRS' ability to investigate illegal activity. Enhancing the IRS' ability to investigate non-tax related criminal activity appears to be a principal element of H.R. 6300.

The insufficient level of participation of the IRS in the government battle against organized crime and large drug trafficking has repeatedly been cited as a central concern with current law. However, this view misperceives the historic and proper role of the IRS, which is the collection of revenues and the enforcement of tax laws within the constraints of constitutional standards; to portray the IRS as a prinicipal agent in the battle against organized crime is misleading and harmful.

Section 101 of H.R. 6300 would create a broad, new power for the Commissioner of the IRS to seize funds believed to be derived from illegal activity. The "Presumption of Jeopardy in the Case of Illegal Activity Cash" would ostensibly utilize jeopardy and termination assessments as tools of civil enforcement; however, its thrust seems aimed primarily at non-tax related criminal activity. As drafted, this provision is an invitation to governmental abuse.

H.R. 6300 provides little guidance on how the Commissioner will determine whether an individual is engaged in illegal activity; a due process standard is wholly lacking in provision. Ironically, the absence of adequate due process protection is neither likely to enhance respect for the tax system nor encourage voluntary compliance. Moreover, the term "illegal activity" is generously defined to include any violation of federal or state law which is punishable by imprisonment; such breadth in coverage seems far concern for enforcement of tax laws alone.

But most importantly, Congress has already addressed the concern for potential harm when it amended the laws in 1976 to protect the taxpayer from a pattern of documented abuse in this area. In the absence of continued safeguards, such abuse could easily recur.

Sections 131–133 of H.R. 6300 would expand the IRS's summons authority regarding financial records held by third parties. Both the Departments of Treasury and Justice have long sought amendments in this area of the law on the ground that these provisions were used primarily to delay IRS investigations. Section 131 would require that a taxpayer institute a court proceeding to quash a summons served on a third-party recordkeeper, instead of requiring the IRS to initiate an enforcement action following stay of compliance by letter. This proposal is objectionable for two reasons.

First, Section 131 would shift the burden in a summons enforcement proceeding from the government to the taxpayer. This change reverses the basic presumption of our legal system which is that the party seeking disclosure of information must bear the burden of going to court in order to justify that disclosure. Proponents of this change argue that H.R. 6300 simply brings the summons procedure into accord with procedures established by the Right to Financial Privacy Act of 1978 for all other agencies of the federal government. However, since the IRS' routine access to information is vastly greater than any other agency that analogy makes little sense. The special powers of the IRS create a presumption against additional compulsory disclosure.

We also oppose that provision which would abolish the automatic stay of compliance of current law. Proponents routinely cite the excessive delays which allegedly are created by existing law. However, the problem of time delays exists separately from the question of insuance of a stay to disclosure proceedings. Current law provideds for automatic stays precisely because of the presumption against disclosure that exists is a basic element of the process. The question of time delays is properly dealt with by imposing time limits and not by altering a provision which enacts an important policy of privacy protection.

Section 201 et seq of H.R. 6300 is designed to improve information reporting of dividends, interest, etc. It would also exempt the IRS from certain reporting requirements of the Paperwork Reduction Act of 1980; Section 215 would exempt the IRS from referring information collection requests to OMB for approval. The ACLU strongly opposes this exemption.

Among other purposes, the Paperwork Reduction Act serves as a limited check on the exercise of unilateral authority by the IRS in imposing unnecessary paperwork burdens on the public and in securing further access to individual data. An exemption from these requirements would be tantamount to an expansion of authority that would seem unwarranted tin the absence of a demonstration of the adverse impact of these requirements. Moreover, given the already broad authority of the IRS to compel production of individual data, such a demonstration of impact would not be dispositive of our view on the advisability of an exemption.

There is at least one other substantive due process problem which arises under H.R. 6300. Section 402 of the bill could theoretically create a conflict of laws problem for the taxpayer engaged in foreign transaction. The provision would deny a taxpayer a right to introducted evidence of foreign transactions in court proceedings where the information had been withheld in a previous IRS audit. While the purpose of the provision is to give the IRS greater control in monitoring illusive international transactions which deprive the government of substantial revenue, the exclusion of foreign non-disclosure laws as reasonable cause for failure to produce is problematic. A conflict between applicable U.S. and foreign law is inevitable. A more precise formulation of this approach would seem warranted.

The overriding goal of H.R. 6300 in promoting voluntary compliance and fairness is commendable. The ACLU supports those limited changes that would facilitate the process, provided adequate standards of privacy protection are met.

However, those provisions which secondrily promote the IRS role against organized crime, in disregard of due process standards or through unwarranted expansions of authority, must be viewed with concern. Such provisions reflect a continuing expansion of the IRS role in law enforcement in a manner inconsistant with its purpose.

Thank you for the opportunity to present our views.

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE

The purpose of this statement is to present the views of the American Council of Life Insurance on the Tax Compliance Act of 1982 (H.R. 6300) and related bills. Our testimony will focus on the question of withholding on annuity payments. The American Council of Life Insurance is the major trade association of the life insurance business with a membership of 524 life insurance companies which, in the aggregate, have approximately 97% of the life insurance in force in the United States and hold 99% of the assets of all United States life insurance companies. Our member companies also had approximately 6 million annuities in force at the end of 1980.

SUMMARY

We oppose the imposition of a mandatory withholding requirement on a wage withholding basis on insurance companies which make annuity payments. We believe implementing such a withholding procedure will result in considerable administrative burdens and costs to the insurance companies, and consequently a lower annuity payment to policyholders. Moreover, it will be extremely difficult for our member companies to determine the taxable amount of an annuity payment made under a contributory qualified plan. We believe that enactment of the provisions in H.R. 6300 and H.R. 5829 dealing with improved information reporting, together with the existing voluntary withholding system, is a much more desirable way to deal with any compliance gap that may exist in the reporting of annuity payments.

SPECIFIC COMMENTS

Mandatory withholding on annuity payments on a wage withholding basis

Section 301 of H.R. 6300 and section 131 of H.R. 5829 add a new section to the Internal Revenue Code which would treat annuity payments as if they were a payment of wages by an employer to an employee. Unless an individual elects not to have any withheld from his annuity payments, insurance companies would be required to withhold under the general wage withholding rules.

Practical problems.—In the case of annuity payments received by a retired employee under a pension plan which is partially financed by his contributions, only the amount of the benefit that is attributable to his employer's contribution would be taxable. In order for the insurance company withhold the proper amount, it would be necessary to know both the employer and employee contribution. Under most contributory pension plans, it would be impossible for an insurance company to determine these amounts since its records will not show a breakdown between employer and employee contributions. Usually, an employer sends one check for the total amount of the premium for the benefit. The distribution of cost between employer and employee is of no significance to the insurance company.

First payment problems.—Before an insurance company would be able to withhold the correct amount on an annuity payment, it would have to obtain a signed withholding exemption certificate (W-4) from the annuitant showing his marital status, the number of exemptions he claims and the other information required by the Form or obtain this information from another source. In the absence of such Form or information, the insurance company would either have to delay starting the annuity or withhold on the basis of single with no exemptions (a common practice in the payroll area). Thus, there will either be a delay in starting the payments, or the payments will start promptly but with the wrong amount withheld. This problem will be alleviated to a large extent under H.R. 6300 which provides that no withholding is required on the first three months of annuity payments.

Administrative burdens and costs.—Requiring insurance companies to withhold on annuity payments under the general wage withholding scheme would necessitate the installation of new withholding programs based on all the variables which are included for payroll withholding. For example, the program would have to include factors for marital status, number of exemptions, withholding tables and extra exemptions for itemized deductions. Such installation would be a very expensive and time-consuming process. We do not believe that the advantages of withholding on a wage withholding basis justifies the added costs and procedures that will be imposed on insurance companies which inevitably will be translated into lower annuity payments.

Election procedure

Both H.R. 6300 and H.R. 5829 provide a procedure whereby an individual may elect not to have anything withheld from his annuity payment. Under H.R. 6300 the election remains in effect until revoked by such individual. H.R. 5829, on the other hand, requires an individual to make a yearly election in order not to have anything withheld from his annuity payments.

We recommend that it there is mandatory withholding, there be no "election out" procedure. However, if an exemption procedure is provided, we recommend that the election procedure set forth in H.R. 6300 be adopted since, of the two alternatives, it is the more simple and the least costly to administer.

The yearly election procedure set forth in H.R. 5829 will impose undue administrative burdens on insurance companies. It will require the processing of massive amounts of paper and the establishment of a system to receive and process the forms electing out of the system in order to establish that withholding is not required. This result would be clearly contrary to the Reagan Administration's attempt to reduce the regulatory and paperwork burdens on business.

Moreover, while any election procedure will cause substantial confusion and misunderstanding, an annual election will cause the problem to recur annually. As a practical matter, retirees in many cases either fail to file the required form because of inadvertence or forgetfulness or will not file the form in time for the insurance company to process it before making payment. More importantly perhaps is the fact that retirees, many of whom are unsophisticated or in failing health, will not understand the notice sent to them and therefore will not make an appropriate response.

An alternative solution

We recognize that there may be a noncompliance problem regarding annuity payments. However, we believe that mandatory withholding on a wage withholding basis is too comprehensive, unnecessarily burdensome and complex and expensive. Therefore, we recommend that section 301 of H.R. 6300 or section 131 of H.R. 5829 not be enacted.

We believe that a more appropriate alternative is to strengthen the information reporting system. In particular, we strongly support section 214 of H.R. 6300 and section 104 of H.R. 5829 which would amend section 6011 of the Code to allow the IRS to require large payers to file information returns on magnetic tape or in other machine readable form. In this regard, we are pleased to note that many of our larger members are already filing the required information regarding annuity and other payments with the IRS on magnetic tape. Our understanding is that the ability of the IRS to match information received on magnetic tape with individual returns has greatly increased. In addition, payers are now required to furnish a copy of the information return to the payee. In our view, these factors, taken together, should greatly reduce any noncompliance gap that may exist in the reporting of annuity payments.

Withholding of a mandatory fixed percentage and exemption for small payments

If mandatory withholding is going to be required for annuity payments, we believe a much more desirable approach than general wage withholding and withholding of a flat percentage of the amount of the annuity payment. Withholding at a flat rate will remove the practical problems and considerably ease the administrative burdens and costs to insurers which would be involved in implementing withholding on a general wage withholding basis. And, if the flat percentage is set at the appropriate rate, it should not result in any excess withholding for annuity recipients.

As part of this suggested alternative, we also recommend that there be an exemption from withholding for small amounts. Most annuitants are elderly people living on fixed incomes from pensions and Social Security who most likely pay little or no federal income taxes because of low income and large exemptions. Thus, any withholding would be particularly burdensome on this group of people. In addition, it does not seem appropriate or necessary to require this group to elect out of any withholding system that may be imposed, even if the election is a one-time election. Thus, we urge that if there is mandatory withholding on annuity payments, the statute provide for an exemption for annuity payments of $500 a month or less.

Effective date

We urge that if any change is made to the withholding rules regarding annuity payments, insurers be given a sufficient amount of lead time to comply. Developing new computer programs or modifying existing programs to accommodate changes in the law is very time-consuming and costly. The more time that is available to make the necessary changes, the more orderly and less costly those changes will be. Therefore, we strongly urge that insurers be given an adequate amount of time to comply with any new requirements imposed on them.

Commercial annuity

H.R. 6300 and H.R. 5829 (proposed new section 3405(d)(6) and section 3405(g)(4)) both define a commercial annuity as including an insurance contract. We urge that insurance contracts be removed from the definition since in most instances payments under such contracts are not taxable and therefore would not be subject to withholding. To require insurance companies to determine what small portion, if any, of the proceeds from a life insurance contract is taxable, would result in unnecessary burdens and expenses.

The income tax treatment of life insurance death proceeds is governed by section 101 of the Code. Generally, gross income does not include amounts received, whether in a lump-sum or otherwise, under a life insurance contract, if such amounts are paid by reason of the death of the insured. In addition, amounts received under a life insurance contract during the life of the insured are not taxable until the policyholder has received amounts equal to his investment in the contract. In most instances, therefore, amounts received under life insurance contracts would not be taxable and should not be subject to mandatory withholding.

We appreciate having the opportunity to present our views on H.R. 6300 and H.R. 5829. We would be happy to attempt to answer any questions the Subcommittee may have.

STATEMENT OF THE AMERICAN HOTEL AND MOTEL ASSOCIATION

Mr. Chairman and Members of the Subcommittee: The American Hotel & Motel Association is a federation of hotel and motel associations located in the fifty states, the District of Columbia, Puerto Rico and the Virgin Islands, having a membership in excess of 8,200 hotels and motels accounting for over one million rentable rooms. Inclusive in our membership are all of the major hotel and motel chains.

We testified on the charged tips issue contained in Section 103 of H.R. 5829 before the Senate Finance Committee in 1978. At that time, Congress opposed the concept of the reporting of charged tips and enacted a law that prohibited the IRS from requiring the employer to record and report charged tips. Now, we are dealing with opposite recommendations.

We oppose Section 103 of H.R. 5829, "Taxpayer Compliance Improvement Act of 1982", because of its onerous recordkeeping requirements and because it departs from placing the sole responsibility of reporting tip income on the person who receives the tip income. Unlike 1978, this bill does not propose withholding but, to us, it would seem to be the next step once you have changed the reporting burden of the law. In addition, this bill has a so-called small business exemption. Those very few, if any, hotels or motels who would have 5 employees or less, are likely to be small non-credit card establishments.

We are sure you are familiar with the history of the reporting of tip income but we would like to briefly review it here.

From the inception of the tax laws in 1917 until 1965, employers were not involved in reporting on or withholding taxes related to tip income. Employees were merely required to report their tips and pay taxes thereon. In 1965, Congress changed this by making employers report tip income on the employee's W-2 Form for withholding and social security purposes—but again, the report was based on declarations to the employer by the person who received the tip income.

Congress did not do this lightly. The House Report said that, "the only equitable way of counting tips (would be) on the basis of actual amounts of tips received and that the only practical way to get this information (would be) to require employees to report their tips to the employer. (H.R. Report N. 213, 89th Congress, Second Session 96 (1965).)" Section 6053 was added to the code in 1965 for this purpose.

Congress also recognized the common practice of tip splitting and tip pooling and determined that only tips received by an employee in his own behalf would constitute wages or income to that employee. Any portion of a tip which an employee splits or gives to a tip pool is income to the ultimate recipient. As a result of this determination, section 6051 of the code was amended in 1965 to provide that an employer's report of tip income on Form W-2 "shall include only" that tip income reported by the employee to his employer.

The entire legislation history of the 1965 amendments as it relates to taxing and reporting tip income reflects a thorough understanding by Congress of the practices and customs of tipped employees and a deep concern for the accounting problems these amendments would present to employers. This concern was reflected in the House Committee Report in these words:

"The employee would be required to report to his employer in writing the amount of tips received and the employer would report employees' tips along with the employees' regular wages. A provision is included under which the Secretary of the Treasury or his delegate is authorized to issue regulations under which the employer will be permitted to gear these new reporting procedures into his payroll. *It is the understanding of your Committee that regulations will be issued along these lines to the end that the procedures required of the employer with respect to this reporting requirement will be minimal.*" (House Report No. 1548, 88th Cong., 2nd Sess. 11 (1964). (Emphasis added.)

One cannot argue that Congress did not anticipate or have knowledge of charge tips as opposed to tips received directly from the consumer, for the House Committee Report specifically refers to charge tips in these words:

"The employee would be required to report to his employer in writing the amount of tips received and the employer would report the employee's tips along with the employee's regular wages. The employee's report to his employer would include tips paid to him through the employer as well as those received directly from customers of the employer." (House of Representatives Report No. 312, 89th Cong., 1st Session (March 29, 1965).

Congress, then, did not intend that the employer be saddled with a reporting and recordkeeping burden of this nature which this legislation now seeks to impose. For almost two decades the law and the practice has been for the employee to report his tips to the employer.

Despite existing law which requires tipped employees to maintain accurate records of tip income and to make reports of such income in writing to their employers at least once a month, you now propose to require hotels and motels to keep records of all tips charged on credit card slips! In addition, you now propose that the hotels and motels must be the ones to report all of these charged tips for each individual tipped employee to the IRS! This is a total reversal of present law and contravenes the entire history of tip reporting responsibility.

Tips are, and always have been, the property of the employee. The employer is merely a conduit between the customer and the employee. What you want now is for the employer to be an IRS secret agent, checking and reporting on an unknown quantity; i.e., the tip income of the employee the actual amount of which is known only to the employee.

A credit card charged tip is absolutely no indication of income to an employee. The practice of tip splitting and tip pooling assures that this is the case. The charged tips may or may not have gone to the employee who presented the check—we have no way of knowing. The charged tip is an inaccurate indicator of where that tip went.

In 1978, when the Senate Finance Committee was considering this very issue the Committee Report said "The Committee believes that the Practices presently followed by employers in reporting their employees tips to the Service is appropriate and that the new rules proposed by the Service present an unnecessary complication for employers".

At the same time the Senate Finance Committee estimated that by not requiring employers to record and report charged tips the Treasury would lose "less than $5 million" in tax receipts. Now, the Joint Committee on Taxation is apparently saying that the Treasury will recover some $250 to $300 million in tax receipts by requiring employers to report charged tips. We all agree that inflation has been too high betwen 1978-1982 but inflation on tip practices have not changed so much as to justify this drastic difference in numbers.

We strongly believe that existing law is more than adequate for the IRS to increase compliance with the income reporting laws. As we mentioned, it is under present law clearly stated that it is the employees' sole responsibility to report to the employer his or her tip income. While this Committee and the entire Congress in 1978 found it inconceivable to place this unfair burden of reporting on employers, the law was revised to require us for the first time to keep those charged tip receipts for IRS audit purposes and this we have done. Now, the Congress is proposing a significant increase in IRS audit capability including the addition of 5,000 IRS employees. All of the ingredients are present for increased compliance with the law: the law is already on the books that the employee must report his or her tip income; the employer is already required to keep charged tip receipts for IRS audit pruposes; and finally, the IRS has and will have increased audit capability to scrutinize those people who are allegedly consistently under-reporting their income.

The only reason that we surmise that you now propose for the employer to keep and report charged tips is because the IRS has been incapable of enforcing the law. It seems unfair to make us an arm of the Government just because the IRS is not doing an adequate job.

In summary, we reiterate:

The information as to the amount of tip income received by a tipped employee is solely within the knowledge of the tipped employee; the responsibility for reporting that amount of tip income received by a tipped employee under long-standing provisions of law has been solely the responsibility of the tipped employee-whether the reporting was directly to the IRS or as later required by law to be made to the employer. The existing law if properly enforced places an appropriate penalty on a tipped employee for failure of an emplolyee to report or for false reporting. The obligation has always been placed where it properly should be placed—namely on the person who solely knows the amount of tips received. To require an employer to report charged tips would require that employer to report unreliable information on the tip income of an employee. I don't know of a more untenable position in which to place an employer with his or her employees or a greater blockbuster to ruin morale in an employer's workplace. We don't think the law should be changed. Nor, do we believe such a proposed change, which may very well result in a greater use of cash tips and a reduction in the use of charged tips, will help IRS enforcement.

STATEMENT OF KENNETH S. ROLSTON, PRESIDENT, AMERICAN PULPWOOD ASSOCIATION

IDENTIFICATION

This statement is being submitted on behalf of members of the American Pulpwood Association (APA) (address above) by Kenneth S. Rolston, President of that association. APA represents both producers (logging contractors) and consumers (pulp and paper companies) of pulpwood in the United States. Pulpwood is the essential raw material used in the manufacture of pulp and paper products, one of the nation's largest and most productive industries. Our membership includes not only those businessmen and firms that the Internal Revenue Service in past years has alleged are new "employers," but also the businessmen and firms that were unwillingly reclassified by the IRS as "employees."

SUMMARY OF RECOMMENDATIONS

Title II of H.R. 6300 addresses improved information reporting on payments made to independent contractors and new penalties for failure to report such payments. APA believes that these measures to improve IRS ability to match payments made to income reported are inappropriate unless coupled with clarification of independent contractor status.

Improved reporting will not effectively occur unless the issue of determining who is, and who is not, an independent contractor is decided at the same time.

"The Independent Contractor Tax Classification and Compliance Act of 1982" (H.R. 6311), introduced by Congressman Richard Gephardt, addresses both issues in the same bill in a manner that provides certainty and equity for both taxpayers and the IRS. A hearing in this bill and related proposals is scheduled before the Select Revenue Measures Subcommittee on June 11.

Action on independent contractor status and improved reporting should proceed soon to avoid a "gap" following the termination of Section 530 "interim relief" on July 1.

OUR INTEREST IS STRONG

APA's members are vitally interested in the legislative proposal being considered here today. An important part of APA's membership is the independent small businessman managing, operating, and heavily investing in forestry equipment and machinery. Many of these capital-intensive businessmen, the vast majority of whom have employees of their own, found themselves "stripped" of their status as independent businessmen because of the enforcement policies of the IRS. Although the dollar effect of assessments frequently rested upon one of the purchasers of their products or services, the effect of each assessment was no less devastating to the logging contractor. Access to capital sources diminished when financial institutions had knowledge that a governmental agency was challenging their status as independent. Carefully planned retirement programs were suddenly open to challenge. Agreements with other purchasers and access to other forest products markets were jeopardized. There was a natural tendency by purchasers not to do business or to continue to do business with logging contractors allegedly "employed" by another purchaser, especially in those circumstances in which the purchasers were competitors.

The foregoing should bring into focus the central issue that must be properly addressed: Who is an independent contractor for tax purposes? How can improved reporting measure be effective without clarification of status?

WHY THE ISSUES ARE AND SHOULD BE LINKED

The "safe Harbor" provision of H.R. 6311 provide a much stronger incentive for improved reporting than the compliance provisions of Title II of H.R. 6300 do standing along. It is axiomatic that before an individual can comply with tax obligation, he must have some reasonable basis for determining the nature of those obligations. H.R. 6311's first three criteria provide a clear and predictable mechanism for determining status in a business relationship—and therefore knowing one's tax obligations. Control of hours worked and of the scheduling of those hours, principal place of business, if any, and risk of income fluctuation or, alternatively, substantial investment in tangible assets, in addition to being truly indicative of owning a business, can be readily determined. They provide an intelligent and predictable basis for decision.

Tax compliance is further enhanced through the remaining two safe harbor requirements. The H.R. 6311 requirements of a written agreement delineating the actual relationship between the parties along with their corresponding tax obligations and complete compliance with existing IRS regulations concerning information returns are an affirmative action tax plan. These provisions alone will enhance voluntary compliance and ease enforcement problems. When futher supplemented with provisions found in both H.R. 6300 and H.R. 6311 designed to improve and assure greater accuracy in information reporting, enhanced compliance virtually assured.

THE MERITS OF H.R. 6311

H.R. 6311 answers what has been and must be recognized as the fundamental question: who is or is not an independent contractor? It answers that question on a basis that is not only consistent with business realities but also consistent with equitable enforcement of and improved voluntary compliance with tax obligations. Further. H.R. 6311's safe harbor will enable the IRS to guide its enforcement efforts to the correct port—the properly identified non-complying taxpayer. The senseless drift of those resources and their utilization in protracted, unwarranted, unnecessary, and unproductive litigation to simply identify the taxpayer (properly a legislative matter) will finally end.

APA'S TRADITIONAL CONCERN FOR TAX COMPLIANCE

The reputations of many independent contractors have been unnecessarily and wrongfull sullied because of IRS assessments and allegations. In a reputable study concerning contractor compliance (General Accounting Office, Tax Treatment of Employees and Self-Employed Persons, November 21, 1977 GGD-77-99), the GAO concluded that "those taxpayers involved in employee/self-employed redeterminatons had generally paid their income and social security taxes" (p. 24). This finding was predicated upon IRS data from the Taxpayer Compliance Measurement Program which indicated that independent contractors reported 96.7 percent of their gross receipts.

APA believes it is partly responsible for this excellent record and further believes that the record can be improved. We also know that the employment tax laws can be enforced. We know that independent contractors can be found, their tax obligations determined, appropriate action taken, and the level of voluntary compliance enhanced if the correct problem is addressed and the correct solution applied.

A letter from an IRS office suggests a way APA could assist IRS in its mission of achieving voluntary compliance:

(Develop) a continuing education program to make pulpwooders fully aware of their federal tax obligations, both business and personal.

APA has a long and continuing record of tax law compliance education dating back to the mid-1960's. Most recently, over a two year period (1976-1977), in cooperation with the IRS and the Social Security Administration, APA carried out an extensive information and education program, including the production of two films, to help logging businessmen know their proper tax obligations. The effort involved hundreds of meetings on a virtually county-by-county basis in numerous forested states, and reached over 20,000 people. We know this joint effort generated a greatly improved understanding of complex tax law requirements and improved the level of compliance.

Our education efforts continue both at the field level and through distribution of our landmark 145-page publication. How to Stay at Peace With Your Government, which has been through six revisions and has been broadened to include vital information on all federal laws and general information on state laws affecting employers. We intend to continue these educational efforts.

We firmly believe that small logger businessmen want to fulfill their obligations to government and that they will do so if they know what is required.

WHAT IS REALLY AT STAKE

There is a natural human tendency to want the best of all worlds. Who would not prefer complete freedom to make all business decisions, to be accountable to one one, and also to have all the security characteristic of an employment relationship?

However, a difficult choice prevails. To be an independent businessman, one foregoes the security of employment, becomes accountable to the markettplace, and becomes directly responsible for taxes and insurance required. To be an employee, one foregoes the right to determine the manner and means of performance and becomes accountable to an employer, while the employer serves as an agent of government in tax withholding and other legally mandated employer responsibilities.

What is at stake here for all industry and particularly for the logging industry is that this choice could be significantly influenced by a return to IRS practices prevalent before 1979, rather than by business reality and economic factors. The net result over time is a probable massive reallocation and misallocation of scarce economic resources.

Previous IRS practices seem to have been based on the mistaken notion that tax considerations are a "high stakes" factor in making the decision to utilize the services of, buy from, or sell through independent contractors. This narrow view does not comport with the real world of economic relationships that exists in the logging business. The reality of logging is simply that the tax laws so not and cannot determine whether or not employees or independent contractors are used. Rather, regional land ownership patterns, market availability, the nature of regional timber stands, capital equipment considerations, landowner preferences, financing considerations, economic merchandizing of harvested timber, distance to market, and a host of other economic and enterpreneurial forces are at play. In logging, independent contractors exist and are successful only in the business relationships where their products and services maximize the economic return from all resources.

The worst possible consequence for APA members is a return to pre-1979 conditions, when IRS actions had the effect of forcing legitimate independent businessmen into an unwanted and economically wasteful employment status. Ease of tax administration was being placed above the benefits that accrue from independent entrepreneurial activity.

CONCLUSION

H.R. 6311 is the solution to the real problem before us today: status. It brings predictability and clarity to an area that has been made unnecessarily confusing. It will enhance tax compliance without supplanting the common law test and without disturbing economic relationships of proven efficiency and workability. Title II of H.R. 6300 does not address the status issue and therefore cannot effectively serve to enhance tax law compliance.

We fully support better reporting, as found in both H.R. 6300 and H.R. 6311, and we will continue our own efforts to make sure that those in our industry know their proper tax obligations.

ATMI
AMERICAN TEXTILE MANUFACTURERS INSTITUTE, INC.
1101 CONNECTICUT AVENUE, N.W., SUITE 300, WASHINGTON, D.C. 20036
TWX: 710-822-9489
TEL: 202/862-0500

May 26, 1982

Mr. John J. Salmon
Chief Counsel
Committee on Ways & Means
United States House of Representatives
Washington, D. C. 20515

Dear Sir:

This letter is being submitted for inclusion in the printed record of the hearing on H.R. 6300, "The Tax Compliance Act of 1982", and H.R. 5829, "The Taxpayer Compliance Improvement Act of 1982".

The American Textile Manufacturers Institute, Inc. fully supports the enactment of reasonable legislative rules to curtail abusive tax shelter activities and to reduce the compliance tax gap with respect to unreported income. Accordingly, for the most part, ATMI supports legislation along the lines of H.R. 6300, H.R. 5829 and S. 2198, introduced by Chairman Rostenkowski, Congressman Conable and Senator Dole, respectively. However, we are concerned that the pending bills may be acted upon so quickly by the Congress in its eagerness to go after tax dodgers that some of the provisions of the bills may not contain adequate safeguards to protect the honest taxpayer from harassment by overly zealous IRS agents armed with powerful new information-gathering and penalty rules that may be applied indiscriminately against both the tax cheat and the honest taxpayer. Also, ATMI is troubled that substantial administrative burdens may be imposed on the business community in the form of new information returns, complex withholding requirements, and mandatory record-keeping rules without a careful balancing of the benefits to be derived by the IRS against the additional costs of industry compliance.

Our specific comments on the provisions of H.R. 6300 and H.R. 5829 are as follows:

- cont'd -

I. Penalty for Documents Understating Tax Liability

Sec. 122 of H.R. 6300 imposes a new civil penalty of $5,000 on any person (1) who aids or assists in, procures, or advises the preparation or presentation of a return, affidavit or other document which relates to the tax liability of a corporation, (2) who knows that it is likely that such document will be used in connection with the determination of the tax liability of a corporation, and (3) who knows that such document (if so used) will result in the understatement of the tax liability of the corporation.

This new civil penalty is not dependent upon the existence of fraud on the part of the corporation, and may be applied whether or not the persons authorized or required to sign the return, affidavit, etc., have any knowledge of the understatement of tax liability. ATMI is fearful that this new penalty provision may be applied to minor infractions by corporate employees, such as a claim of a small amount of personal living expenses on a company expense account, and that the size of the penalty ($5,000) may be substantially disproportionate to the alleged tax understatement. Present law, which provides for criminal penalties for the preparation or presentation of false or fraudulent documents would appear to be adequate to take care of the egregious case. On the other hand, the proposed new civil penalty could easily be used as a club by an overly aggressive revenue agent to intimidate corporate taxpayers into settling disputed issues in favor of the Government rather than to expose certain of their key employees to harassment because of alleged small misstatements with respect to such items as travel and other reimbursed business expenses.

Also, the Committee reports on the bill should make it clear that a written recommendation by a corporate employee or outside consultant that the taxpayer take a position on its return contrary to IRS rulings or regulations will not support imposition of the penalty unless the position taken is so out-of-line that the return can be viewed as false or fraudulent. In other words, consistent with the language of the bill, the employee or consultant must know that his advice will (not "may") result in an understatement of the tax liability of the corporation.

II. Improved Information Reporting

Sec. 203 of H.R. 6300 sets forth new information return rules for certain payments to non-employees. Among these rules are new reporting requirements with respect to sales of

- cont'd -

products to any buyer engaged in selling products on a direct sale basis (e. g., door-to-door selling) or to any buyer who resells such products to persons who sell on a direct sale basis. A question arises as to whether the original seller will have knowledge of what its initial buyer does with the goods, and whether lack of knowledge provides a sufficient basis for avoiding penalties for failing to file the requirement information returns.

III. Requiring Returns on Machine Readable Tape, Etc.

Sec. 214 of H.R. 6300 is entitled "Information Returns" but it actually applies to all tax returns. This provision gives statutory authority for the Secretary to prescribe by regulation standards for determining which returns must be filed on magnetic tape or other machine readable form. In prescribing such regulations, the Secretary is instructed to take into account (among other relevant factors) the ability of the taxpayer to comply at reasonable cost with such filing requirement.

ATMI believes the main thrust of this provision is well-intentioned, but cautions that a mandatory filing requirement on magnetic tape or other machine readable form should be applied in the first instance on a taxpayer-by-taxpayer basis, taking into account the computer capability of the particular taxpayer, the cost of any new programming that may be required, and the ability of the IRS to process the returns to be filed in machine readable form. To phrase it another way, ATMI would favor this proposal if it could be sure that the Service would limit its requests for returns to be filed on magnetic tape to those that the Government will actually use, such as the matching of information returns with individual tax returns.

IV. Pensions and Other Retirement Income

Commissioner Egger has recently testified that the tax gap for unreported pension income in 1981 is estimated by the IRS to be $2.8 billion. Given the magnitude of the problem, ATMI generally supports the provisions in H.R. 6300 and H.R. 5829 which require withholding on pensions, annuities and certain other deferred income unless the recipient affirmatively elects not to have the withholding rules apply.

This elective feature of the two bills will substantially increase the costs of compliance on the part of payors who are required to notify recipients of the right to elect out

- cont'd -

of withholding, and to keep track of the recipients subject to withholding and those not subject to withholding.

To reduce burdensome paperwork, in the case of annuity payments we would urge the election by the recipient should be effective until revoked as provided in H.R. 6300 rather than on an annual basis, as called for in H.R. 5829. For withholding on qualified total distributions, we generally favor the rules of H.R. 6300 over those of H.R. 5829, but we believe the tax computations should be simplified, and that recipients should receive advance notice from the payor of his or her right to elect out of withholding.

Both H.R. 6300 and H.R. 5829 provide that the new pension withholding rules are to be effective (other than for reports by employers, plan administrators, and certain penalties) for payments and other distributions made after December 31, 1982. ATMI believes that such an early effective date will be impossible for employers and plan administrators to cope with. The implementation period for the new system must include the time required for (a) passage of legislation, (b) preparation by the Treasury Department of draft regulations and forms, and public comment thereon, (c) issuance of final regulations, (d) the necessary modification by employers and plan administrators of their pension payment record-keeping procedures, and (e) notification to recipients of their ability to elect out of withholding and the entry of their elections in the pension plan records. In addition, there will be a need for a massive educational effort to inform recipients about voluntary election procedures and the pros and cons of electing not to have withholding apply.

Although the proposed voluntary withholding systems will be much more difficult for the recipient to understand and for employers and plan administrators to administer than a mandatory system, ATMI supports the voluntary approach at this time because it permits the recipient to take into account his or her own anticipated tax liabilities. However, if the new voluntary system should fail to close most of the compliance gap in the pension area, fairness to all taxpayers may require that a mandatory withholding system be given further consideration.

V. Transactions Outside the United States

Title IV of H.R. 6300 contains numerous provisions dealing with IRS access to tax-related documents located outside the United States, and with proposed changes in the present information reporting system for various foreign transactions. The

- cont'd -

chief problem ATMI has with the proposals is that they lump together illegal, tax-cheating activities with legitimate business operations and provide the same harsh arbitrary rules for addressing problems in both areas.

For example, to overcome difficulties encountered by the IRS in obtaining sufficient documentation to substantiate foreign transactions of persons who are subject to U. S. tax, the bill provides that the taxpayer is generally barred from submitting evidence in court on matters covered in an IRS Document Information Request if the taxpayer has failed to comply in a timely fashion with the IRS request. Nothing is said about the problems faced by taxpayers who encounter an IRS fishing expedition, or patently unreasonable requests for copies of voluminous amounts of books and records of foreign subsidiaries, accompanied by English translations.

ATMI believes that the present delegation of the broad information collecting authority to the examining agent or international examiner, coupled with the new harsh penalty proposal that the taxpayer loses his day in court if he does not respond to the IRS document request within a relatively short period of time, is completely unjustified in the absence of clear and compelling evidence that the taxpayer is engaging in illegal activities abroad, or that he has consistently declined to cooperate with the IRS in the conduct of the examination. At a bare minimum, a taxpayer should not be exposed to such a harsh penalty without having the formal document request which triggers the penalty reviewed and approved at a very high level in the IRS, with the taxpayer being accorded an opportunity to present his position with respect to the scope and relevancy of the requested information, and to discuss the problems presented in complying with the IRS request.

The bill also provides that if a taxpayer fails to comply with a formal document request arising out of any trade or business or activity of the taxpayer, the Secretary may require that the taxpayer maintain books and records for the trade or business or activity in the United States. The thrust of this provision is not entirely clear, but if it is intended to give the Secretary the power to require that books and records of foreign subsidiaries of U. S. companies be maintained in this country, ATMI is opposed to it because of the enormous duplication of time and effort that such a requirement could entail.

In summary, for most U. S. companies having investments abroad, the provisions of present law, particularly §964, provide the Service with an adequate basis for obtaining relevant information from abroad. The major change proposed in the bill, with

- cont'd -

its sweeping new lack of admissibility penalty, goes much too far and places too much power in the hands of IRS agents who may use it as a club to force unreasonable settlements, rather than as a means of acquiring documentation that is actually needed for the examination.

VI. Modification of Interest Provisions

H.R. 6300 provides generally for daily compounding of interest on tax deficiencies and refunds, replacing the long-standing simple interest rule in the Code. One reason given by the Treasury Department for the proposed new rule is that the absence of a compound interest rate in the Code discourages prompt settlement of disputes. In effect, the Treasury is saying that the present simple interest rules may make it cheaper for taxpayers to postpone their tax payments as long as possible. ATMI questions whether there are many taxpayers at to-day's 20 percent simple interest rate charged by the Treasury who are attempting to delay their tax payments because of the absence of compounding. Moreover, a shift to full compounding may encourage the IRS to proceed in a more leisurely manner than at present to close examinations where large tax deficiencies may be involved. As a middle ground, ATMI suggests that the simple interest rule be retained for a reasonable period after the filing of the tax return, say two years, in order to encourage the IRS to commence and complete its examinations on a timely basis.

VII. Paperwork Reduction

Sec. 215 of H.R. 6300 would make the Paperwork Reduction Act of 1980 inapplicable to any rule or regulation promulgated under the Internal Revenue Code or to any information request which the Secretary determines to be authorized under the Code or any such rule or regulation. ATMI opposes this change; we believe that the IRS is responsible for much of the Government paperwork burden imposed on the business community and that continued review of IRS functions in this area by the Office of Management and Budget is appropriate.

VIII. Restrictions on Payment of Interest for Certain Periods

ATMI objects strongly to the proposed limit placed on interest on refunds resulting from operating loss and capital loss carybacks and investment tax credit carrybacks. The rationale given for not starting interest on the refund claim until the actual filing of the claim is that some taxpayers may delay filing their refund claims in order to earn interest on their tax refunds in excess of what they might earn at a bank or other financial

- cont'd -

institution. ATMI believes any problem for the IRS in this area to be very small indeed, and that the proposal to disallow interest in its entirety for periods prior to the filing of a refund claim unfairly rewards the Government. In most carryback claim situations, it takes considerable time after the close of the loss year or excess credit year for the taxpayer to determine the proper amount of the carryback claim. Nevertheless, from the moment the loss or excess credit year ended, the Government will have had the use of the money attributable to the taxpayer's overpayment of taxes for the carryback year, and it seems entirely reasonable that the Government should compensate the taxpayer for the use of its money. Accordingly, we urge that Sec. 502(c) be deleted from H.R. 6300.

IX. Interest Surcharge on Substantial Understatement

The no-fault, non-deductible interest surcharge penalty that would be payable under Sec. 503 of H.R. 6300 because of a substantial underpayment of tax is apparently designed to have a chilling effect upon individual taxpayers taking highly questionable or aggressive positions on their tax returns because only a small percentage of returns are audited each year and because the penalty for being caught is simply the payment of deductible interest on a tax deficiency. Unfortunately, this no-fault penalty provision, as drafted, applies as well to business corporations, whose returns are audited regularly and where substantial audit adjustments are frequently made because of timing issues, and because of the complexity of the tax law and the existence of important unresolved industry audit issues. Moreover, in a volatile industry, such as textiles, the wide fluctuation from year to year in profit levels could almost automatically create a penalty situation in any year in which profits are low and normal audit adjustments arise. ATMI strongly recommends that the proposed substantial understatement penalty be eliminated for all corporations other than electing small business corporations and personal holding companies. If this is unacceptable, the proposed penalty should certainly be deleted for any corporation whose returns are regularly examined by the IRS.

Respectfully submitted,

W. Ray Shockley
Executive Vice President

STATEMENT OF DUNCAN MCRAE, JR., ON BEHALF OF THE AMERICAN TRUCKING ASSOCIATIONS, INC.

SUMMARY

I. The American Trucking Associations, Inc. (ATA) urges that the historic status of the independent truck operator as an independent contractor be maintained.

II. ATA strongly opposes the imposition of a withholding tax upon the limited, and sorely needed, revenues of the independent truck operator.

III. ATA, and the trucking industry in general, is firmly committed to the proposition that all citizens and residents should fully meet their tax obligations.

IV. ATA urges that H.R. 6311, The Independent Contractor Tax Classification and Compliance Act of 1982, be enacted since it is the result of thoughtful consideration of the issue of the tax status of independent contractors, and its reporting and penalty provisions were developed to specifically cover issues that may arise in an independent contractor relationship.

V. ATA strongly opposes the inclusion of independent contractors under the general reporting, and penalty, provisions of H.R. 6300, The Tax Compliance Act of 1982.

STATEMENT

My name is Duncan McRae, Jr., and I am Executive Vice President of Melton Truck Lines, Inc., 1129 Grimmet Drive, Shreveport, Louisiana 71107. I am joined in this statement by Edward N. Delaney, Washington, D.C., our special counsel. We submit this statement on behalf of the American Trucking Associations, Inc. (ATA).

ATA is the national organization of the trucking industry, a federation of associations in the 50 states and the District of Columbia, together with 13 national conferences which represent specialized types of motor carrier operations. As such, we represent all types of motor carriers of freight, both for-hire and private.

We have urged that the historic status of "independent truck operators" as independent businessmen, exercising their entrepreneurial spirit and talents be continued.

Furthermore, we have urged that the limited financial resources of these independent small businessmen not be further strained by imposing a withholding tax upon their receipts, which they so sorely need to meet the great demands imposed upon them by inflation and the fuel crisis, as well as other economic burdens.

The effectiveness of the motor transport system existing in this country today is in no small measure the result of the dedication of these "independent operators". This dedication comes from the fact that the "independent truck operator" is an independent businessman, in control of his own work habits, and to that extent in control of his own destiny.

The "independent truck operator" is the classic example of the American dream of owning your own business—"working for yourself"—and, therefore, is the prototype small businessman.

Their continued existence as small businessmen, and the vitality of this country's motor transport system, which is so heavily dependent upon their entrepreneurial spirit, demands that the "independent truck operators" status as independent contractors, their historic status, be continued unimpaired. Therefore, we support a legislative effort to establish certain so-called statutory "safe harbor" rules based upon the common law, in addition to the common law rule of Section 3121 of the Internal Revenue Code (Code), to determine an "independent operators" status as an independent contractor.

Consequently, H.R. 6311, The Independent Contractor Tax Classification and Compliance Act of 1982, introduced by Congressmen Gephardt and Conable, that encompasses reasonable safe harbor rules that take account of the operating practices of the trucking industry has the strong support of the trucking industry.

While we have strongly opposed the imposition of a withholding tax upon the revenues of the independent truck operators, we have not, and do not, countenance taxpayers avoiding or evading their fair share of the tax burden imposed upon our citizenry. All must shoulder the financial burden of supporting our Government.

We have recommended, and supported, substantial increases in the penalties for failure to file information returns, and for failure to supply correct taxpayer identification numbers. We also support any reasonable additional reporting that can be useful to the service in its work to improve compliance levels. H.R. 6311 takes full account of these needs. The penalty and reporting provisions of that bill are drafted specifically to take into account the issues that might arise in an independent contractor relationship.

On May 13, 1982, the Honorable Fortney H. (Pete) Stark announced that his Subcommittee on Select Revenue Measures would hold public hearings on issues relating to the classification of workers for Federal employment tax purposes commencing on June 11, 1982. Such hearings will, we are certain, consider H.R. 6311, as well as other bills and proposals dealing with independent contractor classification issues.

Certainly, the Subcommittee will also consider the reporting and penalty proposals of H.R. 6311 since they were specifically developed for, and tailored to, the independent contractor relationship. We submit that enacting legislation that is directed specifically to those issues arising out of the independent contractor relationship to the general reporting and penalty rules of the tax code. Such general rules must be broadly drawn to be effective; they cannot cover the issues that arise out of the independent contractor relationship nearly as effectively as legislation directed to this specific relationship.

We submit, therefore, that H.R. 6300 should not treat the independent contractor relationship. We urge that H.R. 6311 be enacted.

THE ASSOCIATION OF THE BAR
OF THE CITY OF NEW YORK
42 WEST 44TH STREET
NEW YORK 10036

COMMITTEE ON TAXATION

DAVID R. TILLINGHAST
CHAIR
ONE WALL STREET
NEW YORK, N.Y. 10005
(212) 943-6900

ROBERT S. ENRIGHT
SECRETARY
ONE WALL STREET
NEW YORK, N.Y. 10005
(212) 943-6900

March 15, 1982

The Honorable Robert J. Dole
Chairman, Committee on Finance
2227 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Daniel Rostenkowski
Chairman, Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Dole and Chairman Rostenkowski:

The present system of auditing partnership returns has severe inadequacies, summarized below, both from the point of view of the Government and the taxpayer. Improving that system is among the most pressing items on today's tax legislative agenda.

Our Committee has concluded that the problems and difficulties experienced both by the Service and by taxpayers are best addressed by adopting a "unified proceeding" approach under which all partnership audit questions would be dealt with in a single administrative proceeding and, if necessary, a single judicial proceeding, separate from the audit and judicial proceedings for non-partnership items in the individual partners' tax returns.

The present system is inadequate because the partnership's income is reported on a separate information return, but proposed adjustments resulting from an audit of that return can only be dealt with in separate administrative proceedings for each individual partner. Major problems arise under the present system where the partners are located in different audit districts, are very numerous, or have differences of opinion on how to respond to the Service's proposed adjustment of the partnership return. The problems are multiplied where a single taxpayer has interests in a number of partnerships.

Thus, for many partnerships, a careful audit of a partnership tax return can be achieved under the present system only by obtaining separate extensions of the statute of limitations from the individual partners. The Service has reported considerable difficulties and great expenditure of revenue, time and manpower in coordinating the efforts to obtain such extensions in the various audit districts in which the partners may be located, and in identifying the ultimate taxpayers when multi-tier partnerships are involved. In addition, individual partners are harried and inconvenienced when requested to grant extensions which might apply to non-partnership items and may find themselves unable to close out a year for other items because of the continuing audit of the partnership items.

Apart from statute of limitations problems, handling cases of five or ten (in some cases, thousands) of different partners in different districts taking different positions causes great duplication of effort and administrative (and ultimately judicial) difficulty.

Settlements also are made harder to reach where neither the Service nor any taxpayer representative can control the case. And the bias of the present system toward individual partner decisions on proposed adjustments creates a potential for inconsistent treatment of a single partnership item for different partners.

The deficiencies in the present system have produced severe administrative burdens as a result of the vastly increased use of the partnership format for the conduct of business and investment activities during the past 15 years. It seems unlikely that this growth and its resulting pressures on the present audit system will abate. Moreover, the recent reduction of the maximum individual tax rate to 50% brings it close enough to the maximum corporate tax rate to make the single tax partnership format attractive to avoid the double taxation of income implicit in the corporate form of doing business, particularly where a Subchapter S election is undesirable or unavailable.

Our Committee has therefore concluded, as indicated above, that a "unified proceeding" system should be adopted to replace the present system for auditing partnership returns. On this basic policy question our conclusion accords with the view already expressed by the American Bar Association, the American Law Institute and the Commissioner of Internal Revenue.

Under the "unified proceeding" approach, there would be a separate statute of limitations for partnership items applicable to all partners, a single partnership proceeding at each administrative level, and a single judicial proceeding in which the partnership could contest any final Service adjustment.

The implementation of the "unified proceeding" approach presents certain ancillary issues which must be addressed. These include the extent to which individual partners should be offered an opportunity to participate with the partnership representative in the administrative and judicial processes; the manner in which the rights of dissenting partners to disagree with the position of the general partner or other authorized representative of the partnership should be taken into account; the manner of forum selection and, in this connection, the determination of the amount of tax required to be prepaid to confer jurisdiction on a "refund claim" forum; the extent to which individual partners should be permitted to make separate settlements with the Service outside the unified proceeding for their shares of partnership items; and the determination of appropriate transitional and effective date rules.

We recognize that various approaches are possible to resolve these ancillary issues, as reflected in a number of detailed draft proposals published in the past few years to implement the unified proceedings concept. We are confident, however, that such variations as exist among the various draft proposals do not affect the basic policy judgment favoring the adoption of a unified proceeding for partnership audits. Moreover, our initial broad review of the draft proposals indicates that each proposal benefits from the contributions made by its predecessors and represents not so much a different viewpoint as a more advanced stage of development of the contours of a sound statutory scheme.

Our Committee is further of the view that the change to a unified proceeding is a procedural improvement that should replace the present system of partnership audits generally and should not be limited to designated categories of partnerships. Apart from the definitional difficulties that any such limitation would entail and the complexity that it would introduce of dual partnership audit regimes, it would not in our view serve the basic objective of promoting a fair and efficient resolution of partnership audit issues.

This letter conveys our Committee's basic policy decision favoring the adoption of the unified proceeding approach to partnership audits. A concrete legislative proposal to implement this approach is nearing final shape within the Internal Revenue Service. Our Committee plans to supplement this letter with its comments and suggestions on the particular provisions in that proposal.

Very truly yours,

David R. Tillinghast

David R. Tillinghast
Chairman, Committee on Taxation
The Association of the Bar
of the City of New York

cc: Mark L. McConaghy, Esq.

Department of the Treasury

The Honorable John E. Chapoton
David G. Glickman, Esq.
William S. McKee, Esq.

Internal Revenue Service

The Honorable Roscoe L. Egger, Jr.

LORD, DAY & LORD
25 BROADWAY
NEW YORK, N.Y. 10004

R. PALMER BAKER, JR.
HENRY deFOREST BALDWIN
EUGENE F. BANNIGAN
JOHN F. BARRY, JR
DAVID H. BOTTOMS, JR.
THOMAS D. BRISLIN
PETER S. BRITELL
F. SEDGWICK BROWNE
JOHN W. CASTLES 3d
MICHAEL A. CHAPNICK
RICHARD G. COHEN
PAUL H. DeLANEY, JR.*
GENEVIEVE L. FRAIMAN
SAMUEL S. FRIEDMAN
VINCENT R. GILMORE
JOHN D. GORDAN, III
EMERY W. HARPER
STEPHEN M. HUDSPETH
FRANKLIN G. HUNT
JACK P. JEFFERIES
PETER L. KEANE
RORY KELLEHER
REIGH F. KLANN
JOHN J. LOFLIN
JOHN H. McBAINE
JOSEPH F. McDONALD
DAVID H. MARKS
MICHAEL J. MURPHY
GORDON L. NASH
PETER J. PETTIBONE
NORMAN H. SEIDLER
J. EDWARD SHILLINGBURG
J. BOND SMITH, JR.
GORDON B. SPIVACK
MARK THOMAN
CHARLES R. WALKER, III
JOHN K. WATSON, JR.

*ADMITTED TO PRACTICE IN DISTRICT OF COLUMBIA AND FLORIDA ONLY

TELEPHONE (212) 344-8480
CABLE: LORDATTY, NEW YORK
TELEX: 12-8210 (WU)
62589 (WUI)

HERBERT BROWNELL
COUNSEL

ONE LAFAYETTE CENTRE
1120 TWENTIETH STREET, N.W.
WASHINGTON, D.C. 20036
TELEPHONE (202) 785-1766
CABLE: LORDATTY, WASHINGTON D.C.
TELEX 89856

MORGAN HOUSE
1 ANGEL COURT
LONDON, EC2R 7HJ

TELEPHONE (01) 726-4481
CABLE: LORDATTY, LONDON EC2
TELEX 291629

June 11, 1982

The Honorable Daniel Rostenkowski
Chairman, Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rostenkowski:

I wish to comment on the proposed legislation to provide for partnership level audits (Title VI of H.R. 6300) which I hope will receive favorable consideration by your Committee.

I am writing this letter in my personal capacity. However, for the last six years I have been the Reporter for Subchapter K in the American Law Institute's Federal Income Tax Project. As Reporter, I have worked with lawyers, both in private practice and in teaching, analyzing and suggesting improvements in the method of taxing partnerships. I also have considerable experience with partnership taxation as a practitioner.

As you may know, one of the major proposals of the American Law Institute is for a partnership level audit procedure. A copy of the Institute's audit proposal was published in 1981 and is available to your Committee. We concluded that a partnership audit system is an important and pressing need. I therefore welcome the proposed bill as an essential step towards a more orderly system for taxing partnerships.

There are a number of differences between the American Law Institute proposal for partnership audits and H.R. 6300. In some cases, the bill represents a further working out of principles we have proposed; this further work, reflected in

H.R. 6300, has resulted in improved recommendations. In some instances, such as the provisions for settlements and judicial proceedings, the bill would provide greater rights to individual partners than does the American Law Institute draft. The Institute's proposals are more restrictive on some issues than H.R. 6300 because we believed these restrictions were necessary for an efficient audit system. To the extent that the Treasury Department believes partnership audits can be successfully conducted even without these restrictions on taxpayers, the H.R. 6300 solutions may well be preferable.

There are several respects in which the proposed bill would impose greater limitations on taxpayers than does the American Law Institute proposal. The most notable of these is the restriction that the proposed bill would place on refund proceedings involving partnership items. In this respect the American Law Institute proposal differs from 6300. Furthermore, I have not attempted here to reconcile all the differences between the two proposals. Nevertheless, I believe that on the whole, H.R. 6300's provisions for partnership audit would be a great improvement over present law and should receive favorable consideration by your Committee.

These are, of course, my personal views and should not be taken as views of the Institute which are reflected only in its published materials.

Sincerely yours,

Richard G. Cohen

BUSINESS ADVISORY COUNCIL ON FEDERAL REPORTS

Founded in 1942

1001 Connecticut Avenue, N.W., Suite 925, Washington, D.C. 20036 • (202) 331-1915

Chairman—Eugene J. Hardy
Vice Chairman—John C. Ellis
Vice Chairman—James L. Morrison
Treasurer—William M. Schofield
Assistant Treasurer—Wade S. Williams
Counsel—Thomas M. Brennan
Executive Director—David M. Marsh

BACFR's mission is to minimize federal paperwork burden and assure meaningful reporting programs in the public interest.

Board of Governors

CARL A. BECK
Charles Beck Machine Corporation
A. DEWEY BOND
American Meat Institute
THOMAS M. BRENNAN
Attorney
BERNARD S. BROWNING
General Business Services, Inc.
JAMES P. CARTY
National Association of Manufacturers
THOMAS R. DAUGHERTY
Edison Electric Institute
JOHN C. ELLIS
Associated General Contractors of America
THOMAS B. FAULS
National Electrical Manufacturers Association
JOSEPH S. FINCH
E. I. duPont de Nemours & Company, Inc.
JOHN H. FITCH, JR.
National Association of Wholesaler-Distributors
ALLEN R. FRISCHKORN, JR.
GTE Service Corp.
TERENCE J. GALLAGHER
Pfizer, Inc.
HOWARD V. HAGENBUCH
Eaton Corporation
EUGENE J. HARDY
Gerber Products Company
S. N. HELTSLEY
United States Steel Corporation
JAMES F. C. HYDE, JR.
Grocery Manufacturers of America, Inc.
S. M. INMAN, JR.
American Iron & Steel Institute
CHARLES L. JOHNSTON
Gulf Oil Corporation
WAYNE E. KUHN
Texaco (*Retired*)
LOUIS F. LAUN
American Paper Institute, Inc.
J. H. LERSCH
Aluminum Company of America
HARVEY A. LEVINE
Association of American Railroads
HERBERT LIEBENSON
National Small Business Association
CHARLES MACBETH
Hughes Aircraft Company
JOSEPH F. MILLER
Trade Group Associates, Inc.
ROBERT W. MOORE
Financial Executives Institute
JAMES L. MORRISON
Esmark, Inc.
J. ALLEN OVERTON, JR.
American Mining Congress
WILLIAM M. SCHOFIELD
Financial Executives Institute
LEWIS A. SHATTUCK
Smaller Business Association of New England
CHARLES W. STEWART
Machinery and Allied Products Institute
E. ELWOOD TIPTON
Milk Industry Foundation
VINCENT T. WASILEWSKI
National Association of Broadcasters
DENNIS A. WATSON
R. J. Reynolds Industries, Inc.
WILLIAM J. WAY
General Motors Corporation
DONALD F. WHITE
American Retail Federation
WADE S. WILLIAMS
Deloitte, Haskins & Sells

May 12, 1982

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

This letter is in response to your announcement of May 7, 1982, that the Committee on Ways and Means had scheduled a public hearing on H.R. 6300, "The Tax Compliance Act of 1982," and H.R. 5829, "The Taxpayer Compliance Improvement Act of 1982."

The comments of the Business Advisory Council on Federal Reports are limited to Section 215 of H.R. 6300 and Section 202 of H.R. 5829. These sections would exempt Internal Revenue Service (IRS) reporting and recordkeeping requirements from the review and comment provisions of the Paperwork Reduction Act of 1980 (P.L. 96-511).

During the Ninety-sixth Congress, we made the following statement on the proposed 1980 Act to the then Subcommittee on Federal Spending Practices and Open Government, Senate Committee on Governmental Affairs:

> "To carry out the philosophy that 100% of federal reporting requirements, not just 25%, should be subject to central (Office of Management and Budget) review, we support the revision of the definition of "Federal Agency" to include all agencies. In the absence of such a provision, the chance of collection of ******* unduly burdensome, not to mention meaningless, data is infinitely greater." (Emphasis added)

For the reasons cited above, which remain valid, and because benefits to the public are provided by independent, impartial OMB review, we strongly recommend deletion of the exemption for the Internal Revenue Service from any bill that might be reported by the Committee on Ways and Means.

Enactment of either Section 215 (H.R. 6300) or Section 202 (H.R. 5829) would preclude the current opportunity for public commentary at the OMB level for forms totalling about half the federal reporting burden on the public. We suggest that removal of this major portion of the paperwork burden from the review process could be extremely damaging to taxpayer confidence and would likely not help reduce the "revenue gap" at which, as we understand it, both bills are aimed.

In this connection, small businesses - severely impacted by tax reporting requirements - would be most adversely affected should the protection afforded by the Paperwork Reduction Act be removed.

We are in complete agreement with the views of the Congressional watchdog agency, the General Accounting Office on this important subject. In recent testimony (April 14, 1982) before the Senate Subcommittee on Federal Expenditures, Research and Rules, GAO said, in part:

> "Leaving IRS subject to the act (P.L. 96-511 - The Paperwork Reduction Act of 1980) would not prevent it from levying new, needed reporting requirements. The act does not interfere with the collection of information clearly needed to carry out agency responsibilities.
>
> "Further, IRS can only benefit from adhering to all requirements of the Paperwork Reduction Act. In several prior reports we have pointed out weaknesses in IRS' use and management of information which have led to higher costs or inefficiencies. In April 1981, we testified on problems experienced by IRS in administering the Crude Oil Windfall Profits Tax Act of 1980, including delays in designing its computerized information system to support the agency's information needs. The Paperwork Act was designed to help agencies solve these kinds of information management problems by requiring the establishment of appropriate organizational and management structures. Successful implementation of the Paperwork Act -- not exemption from it -- would seem to be what is needed for IRS to improve its administration of the tax laws through more efficient collection, processing, and use of information." (Emphasis added)

It is important to note that the authority granted OMB under the Paperwork Reduction Act extends only to federal information - gathering and recordkeeping requirements - whether or not such requirements are issued under regulations.

We do not believe OMB review procedures unduly delay issuance of tax forms. Whenever necessary, IRS may utilize the "fast track" procedure whereby any agency head may request expedited OMB approval. (See Section 3507(g) of P.L. 96-511.) The OMB First Annual Report under the Paperwork Reduction Act reveals approval of all 17 "fast track" requests by agencies made April 1981 - February 1982. In 1981, with a new major tax law passed and all taxpayers, including business, anxious to have copies of the revised tax forms, OMB granted prompt clearance of IRS submissions.

As paperwork is our sole area of activity, we take no position on the other provisions of H.R. 6300 and H.R. 5829.

We respectfully request that these views be made part of the printed record of the Committee's hearing on H.R. 6300 and H.R. 5829.

Sincerely,

Eugene J. Hardy

Eugene J. Hardy
Chairman

EJH:cdd

STATEMENT FOR THE CHAMBER OF COMMERCE OF THE UNITED STATES BY DAVID E. FRANASIAK, DIRECTOR, TAX POLICY CENTER

On behalf of the Chamber of Commerce of the United States, representing over 240,000 business, trade association, and local and state chamber members, we welcome the opportunity to submit testimony on H.R. 6300, the Tax Compliance Act of 1982.

SUMMARY

The Chamber commends the committee, Chairman Rostenkowski and Representative Conable for their efforts to improve taxpayer compliance, and support the basic objectives of H.R. 6300 and H.R. 5829. Our comments on S. 2198, the Senate counterpart to H.R. 5829, are outlined in the attached letter which we have sent to members of the two tax writing committees.

The success of our self-assessment tax system depends on all participants feeling that they are not being burdened by excessive reporting requirements and inequitable sanctions. For these reasons several provisions should be re-examined and modified.

Expanded reporting requirements

Title II of H.R. 6300 would provide a separate reporting requirement for payments to persons who are not employees and certain direct sellers. Generally, if the taxpayer's payment to the non-employee is $600 or more per calendar year or if the person sells products worth more than $600 or more to any buyer engaged in selling such products on a direct sales basis or to other persons so engaged, he would be required to file an information report to the IRS and the payee or buyer respectively.

This provision may require small businesses to report the transactions on a cash basis to the IRS even though it is not the proper period for accrual basis taxpayers. This may result in taxpayers receiving documents of little use to them in preparing their tax returns, and may well increase the number of instances in which the taxpayer must communicate with the IRS, at additional cost to the taxpayer and the IRS. Over time, small business persons may begin to routinely question the accuracy of these "official forms" and there may be an adverse public reaction to all information reports including the more useable forms such as the W-2.

We recognize that extended information reporting may be helpful; however, we are aware that the IRS receives more information today than it can effectively match against filed returns. The 1981 Annual Report of the Commissioner states that only 26 percent of the 300 million paper documents filed will be compared to the returns. These paper documents are costly to prepare and are particularly burdensome to small business. It would appear that attention and resources should be focused on greater utilization of data already being filed than in increasing the number of forms, many of which may not be processed.

Computation of interest carryback

Under present law, interest on tax refunds, credits and offsets runs from the date of the overpayment, that is, the day after the end of the loss year to a date not more than 30 days before receipt of the refund. Under the bill, no interest would be paid on a late return if the refund is made within 90 days after the return is filed.

An overpayment resulting from a net operating loss carryback, a net capital loss carryback, or credit carryback would be treated as having occurred on the due date of the return, including extensions, for the year in which the carryback arose.

If enacted, this provision would create great hardship for many taxpayers. It runs counter to the Congressional intent to allow corporate taxpayers to extend the due dates of their returns for periods of business tax return preparation. This rule would deny interest for a substantial period of time. The larger and more complex the business, the longer would be the delay.

Furthermore the provision does not solve the problem, if one exists, of a taxpayer who seeks to take advantage of an artificially high interest rate, and delays filing of carryback claims. Such taxpayers would still be given this opportunity by filing the return for the loss year by the original due date but delaying the filing of the carryback claim.

The present provisions governing applicability of interest on carrybacks are well thought out and were enacted to correct problems similar to those that the proposed legislation would again create; present law is fair and doesn't penalize taxpayers unable to prepare returns without utilizing the extended time periods permitted under the code.

Substantial understatement of liability

The bill provides for a "no fault" interest surcharge that would be non-deductible and payable because of the greater of a 10 percent or $5,000 understatement of a taxpayer's actual tax liability. The penalty is set at 20 percent of the applicable interest on the underpayment. Since it is a non-deductible penalty, it is in effect an increase in the interest charged a taxpayer for taxes due. Although this provision is evidently designed to deter participants in tax shelters and others taking "aggressive" positions, the effect would be much broader. Typically, corporate returns (and in the case of most small business persons, individual returns) contain many judgments as to the treatment of items on which advance guidance from the IRS is difficult to locate, unavailable, or ambiguous. The documentation required to assure "adequate disclosure" could thus lead to large increases in supplementary filings on tax returns, creating a major additional burden for both taxpayers and the IRS.

Individual retirement accounts (IRAs)

The bill would increase the rate of the excise tax on early distributions from IRAs from 10 to 15 percent. This provision has nothing to do with tax compliance per se, and appears to be included in the bill to raise revenue to the Treasury.

IRAs are an important part of the Economic Recovery Tax Act of 1981, which we strongly support, and are designed to encourage savings. This proposal should be stricken from the bill and be the subject of separate hearings.

Pensions and other retirement income

The bill would require withholding of designated distributions (private pension retirement and annuity payments from pensions and profit sharing plans). The withholding rate would be determined by the nature of the distribution (lump sum or periodic).

We believe that mandatory withholding on pension distributions is unnecessary and burdensome. There is little evidence that noncompliance is a major problem with respect to pension income, and requiring withholding on all distributions would inconvenience or penalize the vast majority of pensioners who are complying. In addition, withholding would add substantially to paperwork for both fiduciaries and the IRS. Congress should explore less onerous ways of improving compliance before requiring withholding on all pension distributions.

Illegal activities and compliance

The Chamber is concerned about the effect that Section 101 of the bill relating to jeopardy and termination assessments will have on our tax collection system. Under this provision if a person "possesses, controls or deposits" cash or "has recently possessed, controlled or deposited" cash thought to have been used in an illegal activity, the cash is presumed to be in jeopardy. Further, if an individual is in possession of more than $10,000 cash which he does not claim is his and may be presumed to represent gross income of a single individual and the collection of tax in jeopardy, this provision may do little to solve the compliance problem and may well divert scarce resources away from the enforcement of our tax laws.

Authorizing "street grabs" of cash and other assets contributes little to the goal of maintaining an effective tax system. This is not to say that the IRS should play no role in law enforcement. It should and does do its best to enforce the tax laws against drug dealers and other criminals who evade taxes.

Transactions outside the United States

Section 402 of the bill, dealing with documentation outside the United States, generally provides that a taxpayer who fails to comply with a formal document request within the required time (generally 90 days, although it can be extended by the Secretary) will be prohibited from introducing into evidence such documentation. If a taxpayer can demonstrate that failure to produce the documentation was due to reasonable cause, the rule prohibiting later introduction does not apply. Thus, a taxpayer would not be barred from introducing documentation, despite the fact that he did not or could not produce it within the 90-day period, if he demonstrates his failure was due to reasonable cause. However, the fact that a foreign country would impose civil or criminal penalties on the taxpayer for disclosing the requested documentation is, by definition, not to be considered reasonable cause for failure to produce the documents. Therefore, even if a taxpayer is ultimately able to produce the documentation (e.g., where he later obtains foreign government permission for its release), he is nevertheless forever barred from introducing the documentation into evidence by his earlier inability to produce it within the time period granted.

The intent of Section 402 is to alleviate IRS difficulty in dealing with certain foreign transactions which are considerd to be abuses. However, there is a serious issue as the desirability of creating the additional sanctions proposed in the bill because of the broad powers to ensure taxpayer compliance that already exists under current law. The burden of proof in tax matters is generally imposed on the taxpayer. In addition, the taxpayer is required to maintain adequate books and records to substantiate his tax claims, and, if he fails to maintain or furnish such records, the IRS has extensive powers to reconstruct income (see generally Sections 446 and 6001) and to issue assessments (Section 6201), including jeopardy assessments (Section 6861). The additional civil and criminal penalties and powers provided by the Internal Revenue Code would also be applicable to most, if not all, of the situations identified by the staff report (see generally Section 6651, Section 6653, Section 7201, Sections 7206–7207, and Section 7210). The problems relating to delay, while admittedly of concern, are a direct consequence of the requirement that a taxpayer have a full opportunity to contest the validity of proposed IRS action directly affecting him (see Sections 7602–7605). The concern that documents may be produced later in court, preventing the IRS adequate opportunity to fully review the transactions covered, ignores the ability of the IRS under normal rules of procedure to obtain additional discovery and additional time before proceeding with a case. Finally, the power that the courts have under the Federal Rules of Civil Procedure (see particularly Rule 37(b)) to fashion a range of remedies for failure to comply with a discovery order is extremely broad, including the power "to make such orders in regard to the refusal as are just." Thus, a taxpayer who in bad faith, or through fraudulent activity, seeks to avoid his tax obligation, or his duty to furnish information to the IRS, does so at considerable peril. Therefore, in view of the wide power and authority contained in current law and court procedures, it would not generally appear necessary that an additional level of rules, procedures, and sanctions be enacted.

Nevertheless, if it is determined that for policy reasons it is appropriate to add provisions to deal explicitly with foreign-based documentation, then, at the very least, the sanctions imposed should recognize that, in some circumstances, reasonable cause for failure to produce documents may result from the fact that the taxpayer may face civil or criminal penalties in a foreign country.

A rule that per se excludes from consideration of reasonable cause the fact that a taxpayer may otherwise be subject to civil or criminal penalties, in addition to raising a significant due process issue, also is questionable on equitable and legislative policy grounds. In general, such a rule would appear to cover many more cases than the actual target of the legislation, and would severely and unfairly penalize taxpayers acting in good faith who were unable to comply with a request due to circumstances outside their control.

It should be noted that in making a determination regarding reasonable cause, the courts will generally seek an indication that the taxpayer exercised good faith in attempting to comply with the request. Thus, implicit in the reasonable cause defense is that the taxpayer demonstrate good faith, thereby ensuring that the abusive situations to which the bill is directed will not escape the bill's sanctions under the reasonable cause defense.

It is therefore recommended that the present bill be amended to provide that, where a taxpayer can demonstrate he may be subject to civil or criminal penalties in a foreign jurisdiction if he discloses foreign-based documentation, he may, in appropriate circumstances, have reasonable cause for not complying with a request for such information and therefore not be subject to the sanctions of the bill.

Finally, any bill dealing with foreign-based documentation should explicitly provide procedures whereby the taxpayer can challenge the appropriateness of the formal document request. The bill should also provide for a tolling of the time period granted for compliance during the period of such a challenge. This again will ensure that due process requirements are satisfied.

H.R. 6300 presents additional problems in its requirements for transactions taking place outside the United States. However, we have not been able to adequately address these issues in the short period of time permitted for response to this bill. We would be pleased to supply the Committee with additional comments on these problems at a future date.

CONCLUSION

We strongly support the broad objectives of H.R. 6300 and we would be happy to work with you and your staff on these points or any others in the bill.

We respectfully request that this statement be included in the hearing record on H.R. 6300.

CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

April 22, 1982

HILTON DAVIS
VICE PRESIDENT
LEGISLATIVE AND POLITICAL AFFAIRS

1615 H STREET, N. W.
WASHINGTON, D. C. 20062
202/659-6140

The Honorable Charles E. Grassley, Chairman
Subcommittee on Oversight
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

COPY

On behalf of the more than 240,000 business, chamber and association members of the Chamber of Commerce of the United States, I would like to comment on S. 2198, the Taxpayer Compliance Improvement Act.

The size and scope of the compliance problem is of great concern to the business community. The Chamber supports your interest in improving compliance without burdening taxpayers and businesses that are already law-abiding with further mandatory withholding. The success of our self-assessment tax system depends on all participants feeling that they are not being burdened excessively and that others are reporting and paying tax as required.

While we support the basic objectives of S. 2198, several provisions should be reexamined and modified.

Machine processable reporting. Section 104 of the bill allows the Secretary of the Treasury to issue regulations to require reporting of information returns in machine-readable format, starting with filings due after December 31, 1982. Present law allows taxpayers to provide information on magnetic tapes or other mediums, provided the prior consent of the Internal Revenue Service is obtained. The statutory language should contain a safe-harbor provision to allow smaller businesses, which cannot afford machine processing, to continue to submit paper returns.

(over)

In addition, the effective date should be prospective with respect to information to be reported, so that businesses have time to convert their accounting systems. That is, returns covering payments made before enactment should not have to conform to the new requirement, because that would force some businesses to keep two sets of records for 1982.

Restrictions on payment of interest. Section 113 limits interest due on refunds to periods beginning after a return is filed in a form which permits processing. The term "not in processable form" is unclear, and the rule unfairly penalizes taxpayers with complex returns or those without the resources to file quickly. Same standards should be set forth in the bill or Committee report to clarify the exact meaning of "processable form". Moreover, the interest on a refund should depend on the time which has elapsed since the refund was due, not on how quickly a taxpayer submits a return.

This provision is evidently intended to keep taxpayers from delaying refund claims when the interest rate on refunds exceeds market rates. But the semiannual rate adjustments mandated by Section 112 of the bill should keep IRS rates and market rates more closely aligned than at present. In any case, most businesses file returns as soon as they can be prepared and do not need this penalty to induce them to apply for a refund.

Section 113(c) significantly alters the relief given taxpayers suffering net operating losses, capital losses or having credit carrybacks by beginning the interest period at the time a claim for credit or refund is filed. Thus no interest would be paid for the period between the close of the year of the loss or excess credit and the time an application or claim can be prepared and filed. Because of the complexity of business tax return preparation this rule could deny interest for a substantial period of time. The larger and more complex the business, the longer would be the delay.

Penalty on corporate employees, directors and agents. Section 121 imposes a 50 percent civil fraud penalty on corporate directors, officers, employees, or agents who knowingly participate in fraudulent underpayment of corporate tax. This penalty is unnecessary, duplicative, and arbitrary; it should not be enacted.

Corporations are already subject to a 50 percent civil fraud penalty, and their tax advisors and return preparers are also subject to penalties. Officers and others are subject to stockholder suits, dismissal and other sanctions for fraud.

The provision is overly broad and vaguely worded. For example, the definition of "knowing participation in fraud" includes situations where the individual "knew, or should have known", and includes "knowing of and not attempting to prevent" participation by a subordinate in a fraudulent act. What an individual should have known in a given circumstance is a difficult standard to apply or even describe in a clear, unambiguous manner. It will be difficult for taxpayers and the IRS to apply this vague standard to actual situations.

The penalty will hinder companies' ability to hire much-needed managerial talent because people will be reluctant to serve as officers or directors. Indemnity insurance rates will rise, adding to the cost of doing business. The provision will hurt small businesses most, for they have a smaller pool of would-be directors and qualified managers to draw on and can less afford a rise in insurance costs.

Relief from criminal penalty. Section 123 absolves individuals from criminal penalties for failing to file estimated tax when the taxpayer qualifies for a statutory exemption. There is no reason why this relief should not be extended to corporations as well.

Penalty for substantial understatement. Section 125 imposes a new 10 percent penalty for substantial understatement of tax arising from items not disclosed on the return. An item would be considered disclosed only if information on or attached to the return is adequate to apprise the Secretary of the nature and amount of the item.

Although this provision is evidently designed to force participants in tax shelters and others taking "aggressive" positions to identify those positions to the IRS, the effect would be much broader. Typically, corporate returns (and in the case of most small business persons, individual returns) contain many judgments as to the treatment of items on which advance guidance from the IRS is difficult to locate, unavailable, or ambiguous.

(over)

The documentation required to assure "adequate disclosure" could thus lead to large increases in supplementary filings on tax returns, creating a major additional burden for both taxpayers and the IRS.

Withholding on pension payments. Section 131 requires withholding on pension, annuity, and individual retirement account distributions unless the recipient annually elects not to have withholding apply or provide notice that the distribution qualifies for a tax-free rollover. The computation of withholding rates, notification requirements, and annual election by recipients may create heavy compliance burdens for some employers, plan administrators, and fiduciaries. These burdens could be lessened by having a single withholding rate and allowing an exemption election to remain in force unless withdrawn by the recipient, as in the case of wage withholding (W-4) statements.

We strongly support the broad objectives of S. 2198 and we would be happy to work with you and your staff on these points or any others in the bill.

We respectfully request that this statement be included in the hearing record on S. 2198.

Cordially,

Hilton Davis

Hilton Davis

cc: Senate Finance Committee Members
The Honorable Roscoe L. Egger, Jr.
The Honorable John E. Chapoton

CITIBANK

Citibank, N.A.
399 Park Avenue
New York, NY
10043

John F. Rolph, III
Vice President-
Tax Legislation

May 21, 1982

COMMITTEE ON
RECEIVED
MAY 25 1982
WAYS AND MEANS

The Honorable Daniel Rostenkowski
Chairman, Committee on Ways & Means
U. S. House of Representatives
Washington, D. C. 20515

Re: H.R. 6300, the Tax Compliance Act of 1982
H.R. 5829, the Taxpayer Compliance Improvement Act of 1982

Dear Chairman Rostenkowski:

Citibank takes this opportunity to submit written comments on H.R. 6300, the Tax Compliance Act of 1982, which you introduced on May 6, 1982. These comments are also relative to H.R. 5829, introduced by Representative Conable, to the extent that the provisions of the two bills are parallel in nature.

Although H.R. 6300 was introduced on May 6, copies of the bill did not become available until May 11. The pamphlet of the Joint Committee on Taxation which contains a comparative description of the provisions of H.R. 6300 and H.R. 5829, did not become available until May 12. Therefore, there has been insufficient time to analyze the complex provisions of this proposed legislation, and its manifold implications for Citibank and the banking industry in general.

Citibank strongly supports full compliance by taxpayers with the income reporting requirements of the Internal Revenue Code. Therefore, the general objectives of H.R. 6300 and H.R. 5829 are meritorious.

However, the purpose of the attached written comments is to suggest that appropriate attention should be given to a number of problems which are raised by H.R. 6300 and H.R. 5829.

Because of time constraints, these comments are limited to:

Title I, Sec. 102, regarding obligations required to be issued in registered form;

Title II, Sec. 201, relating to expanded information reporting on debt obligations.

1. Obligations Required to be Issued in Registered Form -- Title I, Sec. 102

In general, Sec. 102 would require debt obligations to be issued "in registered form". This requirement would apply to all obligations of the United States (or any Agency or instrumentality thereof) as well as tax-exempt obligations of State and local governments, and corporate debt obligations (excepting commercial paper and other debt obligations with maturities of less than one year).

The term "in registered form", as it applies to this requirement, is ambiguous with respect to its application to U.S., State, and local and corporate obligations. This term is inadequately defined under Section 102 as well as under the current information reporting requirements contained in regulations issued pursuant to Section 6049 of the Internal Revenue Code. The apparent reference to the U.S. Treasury Department's "book-entry" system is also ambiguous and uncertain of application. The Treasury's current "book-entry" rules with respect to U.S. Government obligations are inconsistent with the apparent intent of this section. Moreover, in terms of State and local government and corporate obligations, the "in registered form" language does not accord with the practices of State and local and corporate treasurers in distinguishing between registered and unregistered debt obligations. It is not clear from the language of Section 102 of H.R. 6300, or from the JCT description, what debt obligations are excepted from the registration requirement.

The imposition of registration may have a serious impact on the liquidity of these debt obligations in the financial markets. The impact on the marketability of short-term (in part, depending upon the exceptions) and upon medium-term obligations, including State and local tax-exempt obligations, could be of considerable magnitude. Before these registration requirements are imposed on such a broad scale through Federal legislation, a study of the effects of these proposals on the financial markets should be made.

Section 102 would deny a deduction for interest paid (under Section 163) if a corporate obligation is not issued in registered form. Although the full intent of this and related provisions of H.R. 6300 is not clear, these provisions, if applicable to Eurodollar debt offerings by U.S. firms, would have serious consequences on the marketability of these instruments, as Eurodollar obligations are almost invariably issued in bearer form. (There is little, if any, market for Eurodollar obligations issued in registered form.) Thus, this provision would have the effect of closing off an important source of attracting capital investment for U.S. companies.

2. Information Reporting on Bearer and Other Debt Obligations -- Title II, Sec. 101

The expansion of IRS reporting requirements to cover all debt obligations would have an adverse impact on the liquidity of the capital markets, and the continuing ability of businesses and the Federal Government to borrow through the issuance of short and medium term debt obligations. If the proposal is enacted in its present form, it would require up to a year of lead time for corporate payors, banks, and brokers and securities dealers to develop and implement EDP (as well as manual) systems --- if this in fact can be done --- to comply with these reporting requirements. It would be impossible to report interest and other payments on debt obligations made in the 1981 taxable year, as required by H.R. 5829. The bills, as currently drafted, leave many important questions unanswered which would result in unintentional noncompliance in many situations.

The information reporting requirements of Section 101 would require the computation and reporting of interest, discount, OID, and presumably capital gains, on debt obligations issued in bearer form, and registered obligations --- which are not currently subject to information reporting. These computational requirements would result in misstatements or distortions of reportable income by the individual holders of a large volume of these obligations, particularly secondary market obligations.

Individuals, PC's, etc., invest in secondary market obligations due to the liquidity of the secondary market. A single debt obligation may be transferred in the secondary market several times between the date of issue and the date of redemption. It would be impossible for any bank or other financial intermediary to accurately trace and compute the interest, discount, etc., which is attributable to multiple holders of a debt obligation which has been transferred between the issue and the redemption dates. The incorrect tax liability incurred because an individual redeems a security and is reported to have earned interest over its entire life, when in fact the individual has bought the security at an interim date, will reduce liquidity in the market. This reporting requirement would produce a magnitude of misstatements or distortions of income attributable to individual holders.

Citibank offers its services in working with the Members and the Committee Staffs to develop a fuller understanding of the problems which exist under H.R. 6300 and H.R. 5829. It is respectfully suggested that there are practical methods of solving the problem of more adequate reporting information on debt obligations to the Internal Revenue Service, as an alternative to the reporting requirements which are imposed by these bills. Citibank is carefully exploring these alternatives, and will make recommendations to the Ways & Means Committee in the near future.

Yours very truly,

Ted Rolph

JOHN F. ROLPH, III
Vice President-Tax Legislation
Suite 350
1200 New Hampshire Avenue, N. W.
Washington, D. C. 20036
202-293-4855

Attachment

CITIBANK, N.A.

H.R. 6300 -- H.R. 5829

COMMENTS ON IMPACT OF THE INFORMATION REPORTING PROPOSALS ON BANK MONEY MARKET OPERATIONS, AND FINANCIAL MARKETS IN GENERAL

Prefatory Comment

The comments contained in this memorandum address the impact of the information reporting proposals on bank operations and the financial markets, i.e., bank money market operations and the related impact on financial markets. The memorandum does not address a number of other areas such as the role of a bank as a paying agent (or redemption agent) for corporate commercial paper or corporate bonds, the corporate trust function of banks as it relates to government securities, or a bank's function as an underwriter of governmental securities (U.S. and State and local). All of these areas, in addition to money market operations, would be impacted by the proposal.

I. Implementation Process

The reporting requirements under the proposed legislation presumably would be implemented in either of two ways with respect to each debt instrument:

(1) reporting each transaction as it occurs, i.e., a sale, an interest payment or a redemption; OR

(2) reporting at the maturity and redemption of an instrument, cumulatively, for all holders.

From a compliance perspective, only the second option is enforceable, albeit with serious implications for the financial markets. The compliance burden would be on the issuing entity (e.g., the government, a bank or an issuing corporation).

However, in the financial markets in which the Treasury, Federal Reserve, banks, securities dealers, and brokers play the major role there is no way to maintain such a documented trail of events and attach it to an instrument. Most debt instruments no longer even exist in physical form and it is unrealistic to propose burdening an electronic funds transfer (EFT) system (such as the Federal Reserve security wire) with historic transaction data. Thus the reliance on reporting at maturity places the last holder in a position of probable tax liability for either having interest earnings assigned to him which probably accrued to someone else or requiring the last holder to trace and record the history of each instrument.

A modified system of reporting at the point of each transaction under the first option would limit the cumulative information tracking requirements throughout the financial market system. Copies of transaction confirmation tickets could be designated as 1099's and sent directly to the IRS (this would account for 7,000-10,000 additional 1099's daily from Citibank alone) or summarized daily on a log sheet and submitted to the IRS. Either of these approaches would require minimum program modifications. A single annual summary would also be possible, but the sofeware investment would be significant.

II. Information to be Reported

The basis for compliance under S.2198 is the capture of taxpayer ID numbers associated with individual (noncorporate) customers for every transaction. Most EFT systems within a bank's financial markets group provide for taxpayer ID numbers to be included in the customer record. Citibank is prepared to provide transactional information by taxpayer ID number; however, as we interpret the requirements of the proposed legislation and relate it to the actual functioning of the marketplace, several major problems are presented.

-- unique identification of instruments in marketplace
-- book entry vs. physical securities
-- registered name
-- price vs. profit

A. Unique Identification of Instruments

A negotiable security type is defined by name of issuer and maturity date (for discounted instruments) and name of issuer, maturity date and coupon (for interest-bearing instruments). However, no identification which can be transferred throughout the marketplace distinguishes any single instrument within a group. For example, Treasury bills are issued at competitive auctions. One group of bills might be issued at 95.375, another at 95.3125. The "original issue document" is obviously different and the two initial holders obviously have different profit potential. However, once those bills are traded in the secondary market, that information is lost and they become identical instruments which will both be redeemed at 100 (par) on the same date.

B. Book Entry vs. Physical Securities

Negotiable CDs, for example, are typically physical securities delivered and safekept for the owner. It is theoretically possible to require that whenever a physical security changes hands, the seller would endorse it, report his taxpayer ID information, and record details of the transaction (e.g., price received) thus providing an audit trail right on the security itself. However, these requirements would have a seriously detrimental effect on the negotiability of these instruments. In fact, their negotiability may be altogether impaired.

Treasury bills and many other negotiable securities -- including increasingly CDs and commercial paper (1) -- exist only in book entry form. No physical security exists. No physical endorsement exists. It is inconceivable that the Fed's security wire would be burdened with taxpayer ID information and historic transaction costs.

C. Registration

Although many negotiable securities are issued with a "name" as opposed to in bearer form, rarely is this "name" the legal name of an individual customer. Rather, this name typically is a nominee name used by the safekeeper. Therefore, neither the issuer nor the purchaser would necessarily know who the true beneficial owner was even if a physical endorsed security were presented.

D. Price vs. Profit Reporting

Assuming that a bank could obtain and record taxpayer ID information on a security transaction, the bank could report the information to both the individual and the IRS. However, unless the seller was asked "how much did you pay for this security and when did you buy it," the bank would have no ability to report this profit earned. It is assumed that people would not provide the bank with the profit information either because they did not know (2) or because they refused; if they did provide it, the information could not be verified. If the question were to be asked, the trader might ask it, but then the speed and efficiency of the trading process would be impaired. The trader, however, could (or, under the proposed legislation, would be required) to refuse to do a transaction without the information. If the question were left to operations for follow-up, there would be no leverage in the situation, i.e., if the person refused to provide the information, it would be too late and too costly to cancel the transaction.

Therefore, it is assumed that reporting would be done on a gross price basis. What that means is that every time a security was purchased from an individual, the bank would report the price paid. With sufficient programming changes, transactional information could be submitted after each transaction (7,000-10,000 transactions per day for Citibank alone), in daily summary, or the data stored and aggregated at year-end. As each security type is managed by a separate automated system, separate listings would be submitted. The best format from the IRS' perspective, the annual report, might be formatted something like this:

---

(1) There are currently pilot projects at both Citibank and the NY Fed to convert CDs and CP to book entry form.

(2) Citibank, for example, values its holdings at average cost. This means that if $1MM were purchased at 90 and another $1MM at 92 on the same day, the $2MM would be valued at an average 91. Then if $.5MM were sold that afternoon, its cost basis would be 91. As all the securities are identical (and most do not physically exist), it is impossible to know whether the actual security sold was really bought for 90 or for 92. The problem is the same for an individual.

Instrument A	Taxpayer ID # 1	Transaction date 1	Par amount	Price paid
			Par amount	Price paid
		Transaction date 2	Par amount	Price paid
		o	o	o
		o	o	o
		o	o	o
	Taxpayer ID # 2	Transaction date 1	Par amount	Price paid
		o	o	o
		o	o	o
		o	o	o

(Appendices I-IV step through a simple set of Treasury bill transactions and reports.)

The IRS would receive such a report from each bank system (up to a dozen such systems in the case of Citibank) and from many banks and brokers in the country. The IRS would then have to read and consolidate all the forms and tapes to generate a single individual's record and then manually map the transaction listing the customer's tax return hoping to make sense out of it all. It is submitted that, it would not take many transactions, security types or bank/broker relationships to make this task impossible. The whole process is technically not practical.

III. Effects of Increased Compliance Costs -- Discriminatory Pricing for Individuals

Compliance with the new reporting requirements will involve substantial costs for programming and reporting and also in terms of the time and effort required to obtain incremental information (e.g., to distinguish an individual purchases, p.c., partnership, etc., from a corporation, to ask for taxpayer ID numbers, etc.). These costs will necessarily be passed on to the customer in the form of lower effective yields. Alternatively, issuing institutions may increase the minimum denominations of their securities, again discriminating against the individual. Such an outcome is predictable and will tend at best to tier the marketplace. Eventually institutions may decide not to deal with individuals entirely.

Individuals will be discouraged from purchasing securities in the secondary market because interest over the entire life of the security would be reported as attributable to them for tax purposes. They will be discouraged from purchasing negotiable securities even at issuance, for fear of not being able to sell them at a fair market price prior to maturity.

Therefore, it is possible, if not probable, that two classes of securities would evolve: one sold to individuals, the other to institutions. It could develop that no institution would buy an individual's security for fear of acquiring with it old reporting responsibility.

The record of the government over the past few years has been good in terms of opening up the professional money market to the individual. The D.I.D.C. has worked hard to eliminate interest rate ceilings on small deposits. Money Market certificates and money market funds have provided new investment opportunities to the small investor. The proposed legislation will turn this entire process around and once again will tend to close the individual out of the most lucrative investment opportunities.

IV. Liquidity in the Market

Liquidity in the marketplace can be defined as a function of three factors: (i) the speed of transactions, (ii) the volume of transactions, and (iii) the eligibility of participants. Any event -- including a legislative one -- which decreases liquidity, will have an awesome impact on the U.S. economy. Citibank and Citicorp are just two issuers out of many thousands. Any decrease in liquidity, and specifically any decrease in the real flow of funds sourced from the individual consumer into investments, will hamper the growth of the entire economy.

V. Cost of Compliance

On a preliminary basis, it appears that the one-time programming costs for Citibank's financial markets group would involve at least:

1 man-month of programmin x 8 major FMG systems (Government Securities, Commercial Paper, Certificates of Deposit, Bankers Acceptances, Foreign Exchange, Investment Portfolio, Tax Exempt, Dealer Finance)	$100.0 Thousand

In addition, it would take approximately 200 hours per year for each system to retain and report the required financial transactions:

200 hours run time x 8 FMG systems	$ 4.5 Million

Over time, the cost of these runs should come down through major programming changes aimed at retaining or storing date differently throughout the year. This would likely not happen until the system was completely revised, which could be assumed to occur within three years.

These estimates exclude the cost of providing for storage of customer's prior purchase cost and related profit calculations under the assumption that he would not provide the information. They also exclude the cost of any incremental hardware necessitated by these changes.

These cost estimates do not include costs which would be incurred by the following affected operations or functions:

(i) paying or redemption agent for corporate commercial paper or corporate bonds;

(ii) the corporate trust function;

(iii) bank underwriting of governmental obligations; or

(iv) other affected bank fiduciary operations.

Attached are appendices which illustrate the problem of tracing interest and other income payments on debt obligations, as represented by individual sales and purchases of U.S. Treasury bills:

Appendix I: Treasury Bill - Process Flow

Appendix II: Treasury Bill - Cash Flow

Appendix III: Treasury Bill - Reporting Flow

Appendix IV: Summary Reports to IRS

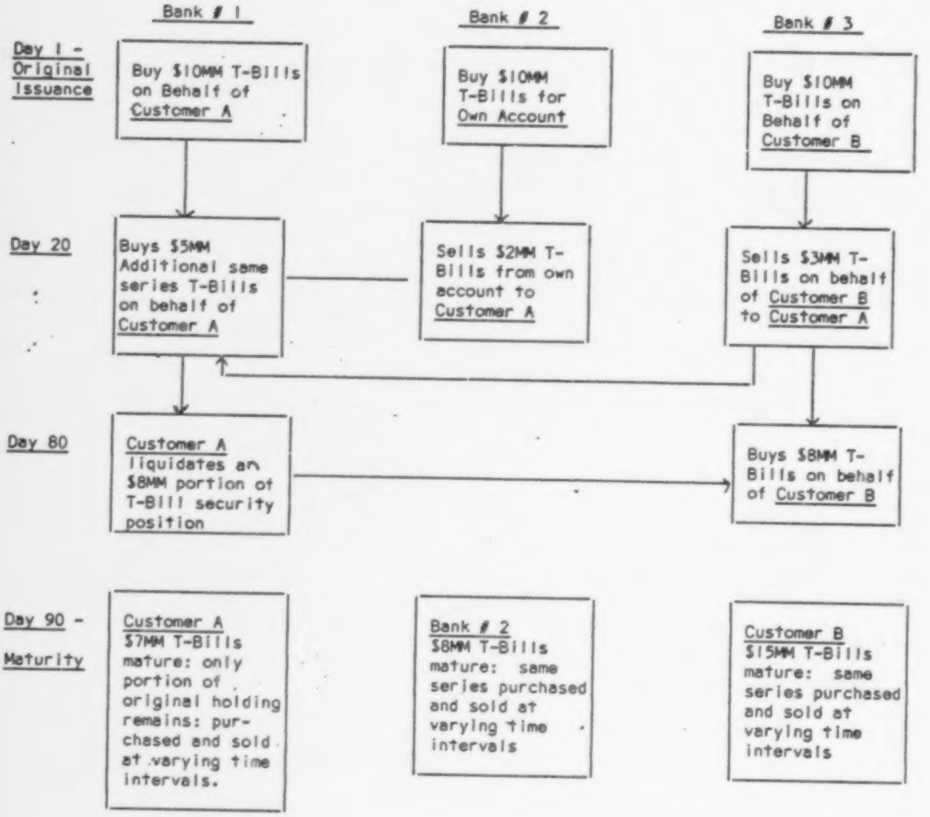
Appendices

CITIBANK, N.A.

May 21, 1982

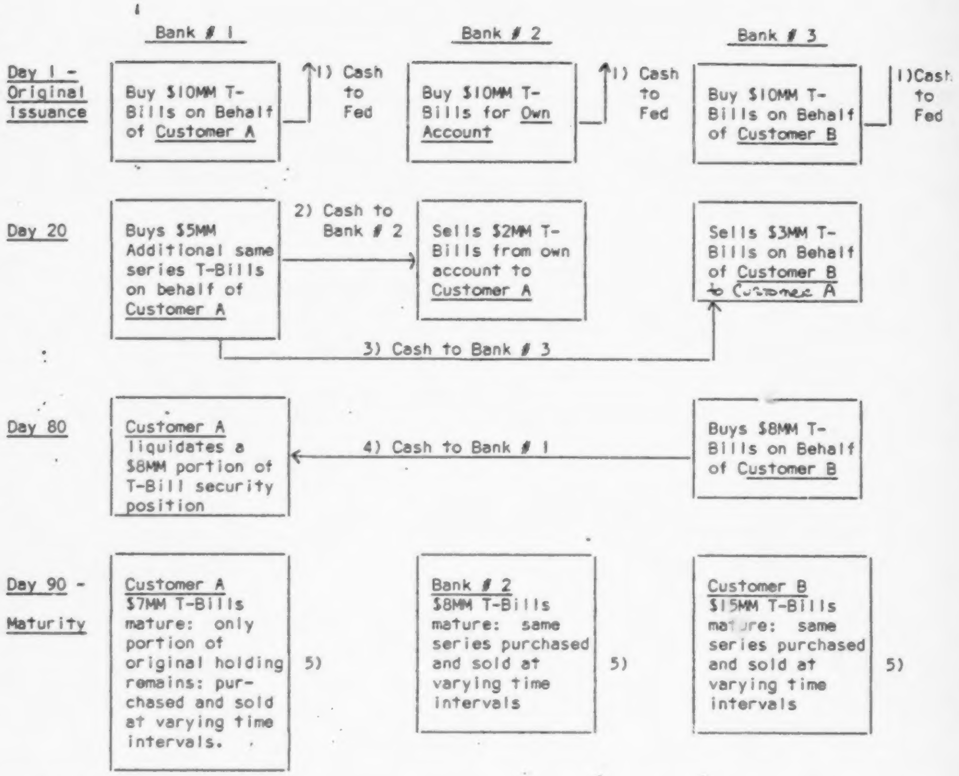
APPENDIX I

Treasury Bill - Process Flow


Bank # 1
Bank # 2
Bank # 3
Day 1 - Original Issuance
Buy $10MM T-Bills on Behalf of Customer A
Buy $10MM T-Bills for Own Account
Buy $10MM T-Bills on Behalf of Customer B
Day 20
Buys $5MM Additional same series T-Bills on behalf of Customer A
Sells $2MM T-Bills from own account to Customer A
Sells $3MM T-Bills on behalf of Customer B to Customer A
Day 80
Customer A liquidates an $8MM portion of T-Bill security position
Buys $8MM T-Bills on behalf of Customer B
Day 90 - Maturity
Customer A $7MM T-Bills mature: only portion of original holding remains: purchased and sold at varying time intervals.
Bank # 2 $8MM T-Bills mature: same series purchased and sold at varying time intervals
Customer B $15MM T-Bills mature: same series purchased and sold at varying time intervals

APPENDIX II

Treasury Bill - Cash Flow


Bank # 1
Bank # 2
Bank # 3
Day 1 - Original Issuance
Buy $10MM T-Bills on Behalf of Customer A
1) Cash to Fed
Buy $10MM T-Bills for Own Account
1) Cash to Fed
Buy $10MM T-Bills on Behalf of Customer B
1)Cash to Fed
Day 20
Buys $5MM Additional same series T-Bills on behalf of Customer A
2) Cash to Bank # 2
Sells $2MM T-Bills from own account to Customer A
Sells $3MM T-Bills on Behalf of Customer B to Customer A
3) Cash to Bank # 3
Day 80
Customer A liquidates a $8MM portion of T-Bill security position
4) Cash to Bank # 1
Buys $8MM T-Bills on Behalf of Customer B
Day 90 - Maturity
Customer A $7MM T-Bills mature: only portion of original holding remains: purchased and sold at varying time intervals.
5)
Bank # 2 $8MM T-Bills mature: same series purchased and sold at varying time intervals
5)
Customer B $15MM T-Bills mature: same series purchased and sold at varying time intervals
5)

1) Original Issue Price (85): Gross cash amount remitted to Fed ($10MM x .85 = $8.5MM each)

2) Selling price (90): Gross cash amount remitted to Bank # 2 (seller) by Bank # 1 (Buyer) = $2MM x .9 = 1.8MM

3) Selling price (90): Gross cash amount remitted to Bank # 3 (seller) by Bank # 1 (Buyer) = $3MM x .9 = 2.7MM

4) Selling price (95): Gross cash amount remitted to Bank # 1 (seller) by Bank # 3 (Buyer) = $8MM x .95 ≐ 7.6MM

5) At maturity, redemption price (100): Gross cash amount remitted to customers & bank by Fed. ($7MM, 8MM and 15MM)

APPENDIX III

Treasury Bill - Reporting Flow

	Bank # 1	Bank # 2	Bank # 3
Day 1 - Original Issuance	Buy T-Bills on Behalf of Customer A	Buy T-Bills For Own Account	Buy T-Bills on Behalf of Customer B
Day 20	Buys Additional same series T-Bills on behalf of Customer A	Sells some T-Bills from own account to Customer A No reporting of bank's interest under compliance bill	Sells T-Bills on Behalf of Customer B 1) Reporting gross payment amount $2.7M
Day 80	Customer A liquidates a portion of T-Bill security position 1) Reporting gross payment amount $7.6MM		Buys T-Bills on Behalf of Customer B
Day 90 - Maturity	Customer A T-Bills mature: only portion of original holding remains: purchased and sold at varying time intervals. 2) Reporting at maturity $7MM	Bank # 2 T-Bills mature: same series purchased and sold at varying time intervals No reporting of bank's interest under compliance bill	Customer B T-Bills mature: same series purchased and sold at varying time intervals 2) Reporting at maturity $15MM

1)-Only know price paid for security. Reporting will not reflect previous holder, original issuance price or subsequent change in price.

APPENDIX IV

Summary Reports to IRS

Reporting Bank / Customer	Bank #1	Bank # 2	Bank # 3
A	Day 80 - 8 @ 7.6MM Day 90 - 7 @ 7 MM		
B			Day 20 - 3 @ 2.7MM Day 90 - 15 @ 15MM

Actual summary of Individual's Transactions

		Par		Money	
Customer A	Bought	$ 10MM	at 85 =	$ 8.5MM	Day 1
	Bought	$ 5MM	at 90 =	4.5MM	Day 20
	sub-total	15MM		13.0MM	Total Cost
	Sold	8MM	at 95 =	7.6MM	Day 80
	Redeemed	7MM	at 100 =	7.0MM	Day 90
	sub-total	15MM		14.6MM	Total Proceeds
				1.6	Net Profit

IRS knows Customer A sold $15MM par for $14.6MM cash; actual profit was $1.6MM (difference between 14.6MM received and 13.0MM cash - but cost is not reported).

		Par		Money	
Customer B	Bought	$ 10MM	at 85 =	$ 8.5MM	Day 1
	Bought	$ 8MM	at 95 =	7.6MM	Day 80
	sub-total	18MM		16.1MM	Total Cost
	Sold	3MM	at 90 =	2.7MM	Day 20
	Redeemed	15MM	at 100 =	15.0MM	Day 90
	sub-total	18MM		17.7MM	Total Proceeds
				1.6MM	Net Profit

IRS knows Customer B sold $18MM par for 17.7MM; actual profit was $1.6MM.

Ernst & Whinney

1225 Connecticut Avenue, N.W.
Washington, D.C. 20036

202/862-6000

May 18, 1982

COMMITTEE ON
RECEIVED
AY 19 1982
WAYS AND MEANS

The Honorable Dan Rostenkowski
and The Honorable Barber Conable
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mssrs. Rostenkowski and Conable:

We share the concern expressed by a number of our clients regarding the provisions of HR 6300, the "Tax Compliance Act of 1982", and of HR 5829, the "Taxpayer Compliance Improvement Act of 1982". The concern relates to the computation of interest on tax refunds generated by the carryback of a net operating losses or unused credits.

In general, a taxpayer's liability for Federal income tax is determined on an annual basis. The allowance of a net operating loss deduction relieves the hardship which can be caused by a taxpayer having taxable income in some years and losses in other years. A net operating loss deduction permits a loss in one year to be offset against taxable income in one or more prior or future years. This is a benefit that is allowed to almost all taxpayers engaged in a trade or business.

The offset of a loss or unused credits against income in one or more prior years usually results in a refund of taxes previously paid. In connection with a refund of taxes, interest is paid to the taxpayer on the amount refunded. The right to interest on a refund or "overpayment of tax" resulting from the carryback of a net operating loss or unused credits necessitates that a measuring point for the computation of interest be established. Under current law, if a refund of tax results from the carryback of a net operating loss or unused credits, the measuring point for purposes of computing the interest earned on the refund is the end of the taxable year which generated the loss. This is the "date of overpayment" used in computing the interest earned on the refunds.

H.R. 6300 would change the date of overpayment for purposes of computing interest allowed on refunds of taxes resulting from a net operating loss or a credit carryback to a prior year. Under Section 502(c) of HR 6300, the date of overpayment would be the due date, including extensions, of the return for the year in which the net operating loss arose.

The purpose of this provision is to curtail the opportunity available to taxpayers with a net operating loss or unused credits to receive interest on the refunds generated by the carryback of the net operating loss or unused credits. Currently, taxpayers can delay filing a refund claim resulting from a net operating loss and by doing so, they can continue to receive interest on the refund for an extended period of time.

We believe that HR 6300 does not adequately address this problem, since technically it merely delays the "date of overpayment" from the close of the loss year to the extended due date of the tax return for the loss year. Thus, taxpayers could still delay filing a refund claim to receive interest thereon for an extended period of time.

HR 5829 also would change the date of overpayment for purposes of computing interest allowed on refunds of taxes resulting from a net operating loss or credit carryback to a prior year. Under Section 113(c) of HR 5829, the date of overpayment for purposes of computing interest would become the date on which a claim for refund resulting from the net operating loss or unused credit carryback is filed. The proposed effective date of this change is March 11, 1982 for interest which would have accrued after that date.

Many taxpayers are not aware of this proposed change in the computation of interest on refunds caused by carrybacks. This problem is further compounded by the March 11, 1982 proposed effective date of the change. In effect, the March 11 date would make the change retroactive.

In practice, a claim for refund of taxes due to a net operating loss or unused credit carryback cannot be filed until the tax return for the loss year (or the unused credit year) has been filed. Thus, for many calendar year taxpayers, it will be impossible to file carryback claims until sometime after June 15, 1982 (the extended due date for taxpayers who have requested an automatic extension of time to file their tax returns). For other taxpayers who will have to extend the due date of the 1981 tax return until September 15, 1982, the refund claim cannot be filed until even later.

We believe it is inequitable to deny interest to these taxpayers when the government has the continued use of their previously overpaid taxes. This is especially true if you consider the fact that interest will continue to accrue in favor of the government on any underpayment of prior years' tax that may be offset by the carryback claim.

From the standpoint of equity, we suggest that interest on refunds due to net operating loss carrybacks or unused credit carrybacks should accrue at least until the extended due date of the tax return for the year in which the loss or unused credit arises. This would permit interest on the refund claims for no more than 8 1/2 months. We believe our suggestion would restrict the incentive for an unreasonable delay in the filing of refund claims consistent with the purposes of the proposed legislation. However, it would not be unfair to those taxpayers who cannot file a tax return shortly after the close of a loss year.

Ernst & Whinney

The Honorable Robert Dole May 18, 1982

If you have any questions or comments regarding this matter, please contact the undersigned or W. Keith Rollins at 202/862-6000.

Very truly yours,

Herbert J. Lerner
Partner-in-Charge
Washington Tax Services

Copies to Members of Ways and Means Committee

STATEMENT OF ROBERT J. JULIANO, LEGISLATIVE REPRESENTATIVE, HOTEL EMPLOYEES AND RESTAURANT EMPLOYEES INTERNATIONAL UNION

Mr. Chairman, on behalf of our general president, Edward T. Hanley, and the 450,000 members we proudly present, may I say what a pleasure it is to submit testimony to this distinguished subcommittee regarding the Taxpayer Compliance Act.

At the outset, I applaud the committee's effort to look at areas whereby additional revenue can be raised which might help to stimulate our troubled economy. Since our international union has been actively involved in some major tax legislation over the past few years, we would like to do whatever we can to assist your committee in their efforts to raise revenue.

In a general sense, it is our belief that the fewer items in a tax bill, and the broader the revenue base, the less controversy such legislation incurs, certainly the subject of the underground economy raises a lot of interesting points. Along with this, we believe a deferral or elimination of the administration's third year of the tax cut might be the best way to start a legislative scenario which would provide some relief to a large number of tax payers.

Therefore, we hope to be able to work with all of you on meaningful tax legislation. We will, however, vigorously oppose any efforts to amend the charge tips provision, since the Congress has reviewed this matter twice in the last four years and wisely rejected the false notion idea being advanced by the IRS, namely that there is substantial non-compliance on the part of tipped employees, and specifically, our members. Your bill, wisely, does not contain this provision.

As most of you know, the hospitality industry is highly labor intensive. Those people employed in our industry including a majority of our members are females, minorities, unskilled, and semi-skilled. At a time when workers are being laid off or their income is substantially reduced because of the economic conditions in the country, this provision on charge tips would only bring more chaos to the marketplace and to the workplace.

As a matter of substantiation, we would like to proceed with a brief review of the recent history of the charge tip provision to bring a historical perspective to this most important hearing. Congress has recognized the common, indeed prevalent, practice of tip splitting and tip pooling, and determined that, in all fairness, only net tips-received by an employee in his own behalf would constitute wages or income to that employee. Any portion of a tip which an employee splits or gives to a tip pool is income to the ultimate recipient. As a result of this determination, section 6051 of the Code was amended in 1965 to provide that an employer's report of tip income on form W-2 "shall include only" that tip income reported by the employee to his employer. It is apparent from the legislative history that Congress was fully aware of the practices and customs of tipped employees, and was deeply concerned that employer's reporting and recordkeeping requirements be minimal. This system has been in effect for approximately 15 years, and there has been no substantiated showing of abuse or problems under it.

In December of 1975, the Internal Revenue Service issued Revenue Ruling 75-400 which unilaterally, and without prior notice or consultation, altered the entire approach of recordkeeping and reporting. This ruling required employers to keep independent records of the amount of charged tips for each employee and to reflect the total amount on the form W-2, whether or not this same amount had been reported by the employee. This ruling changed the rules in the middle of the game, and made the employer the watchdog and compliance agent of the IRS. This ruling was clearly inconsistent with the law and congressional intent. It overlooked the well-known fact that employees receiving tips often share the tips with other employers, and that to tax the employee on the full amount of charged tips allocated to him would be manifestly unfair. It imposed a new and extensive recordkeeping and reporting burden on employers; unjustifiably impugning the honesty of many thousands of tipped employees: and created a source of conflict between employer and employee.

In June of 1976, while Congress was considering amendments to the Internal Revenue Code which would revoke revenue ruling 75-400 and clarify the legislative intent of the prior laws, the IRS issued another ruling, revenue ruling 76-231. The issuance of this ruling was an attempt of the IRS to clarify their own intent, yet only complicated further the requirements for compliance. It did not meet the objections voiced with respect to the early ruling and actually increased the burdens on both the employer and employee.

Specifically, it created new additional complicated reporting requirement for waiters: Continued to require employers to report all tips on a gross basis, including "unreported charged tips"; and created new complicated reporting requirements for employers. The result would have been that employees would report on a net basis, the employer would report on a gross basis, and a reconciliation would have been required somewhere along the line. An administrative nightmare would have been created. Furthermore, it would have subjected employees to taxes on wages they never received, i.e., pooled tips, unless they affirmatively filed a statement with the IRS explaining the circumstances.

I must emphasize at this point that the practice of tip splitting and tip pooling is so general in gratuity occupations that it has been recognized by Congress since 1965 and taken into account in other legislation as well, specifically the Fair Labor Standards Act. In that legislation Congress also declared an intent not to interfere with that time honored practice. In 1976, the Senate passed a clarifying amendment, specifying that the only tips which an employer must report were those reported to him by the employee under the present laws. It would have revoked Rev. Rul. 76-231. Since the controversy arose after the house had considered the Tax Reform Bill, there was not comparable measure in the House version when it went to conference.

The conference committee was very concerned about the problems posed by the new revenue rulings, but was unable to discern final resolution without additional study. Accordingly, the conference committee decided to legislate a two-year moratorium on the new rulings stating that the IRS would not make any changes in the existing tip reporting requirements (through implementation of Rev. Rul. 76-231 or otherwise) before January 1, 1979. This two-year period was set in order that the Congress have an opportunity to look closely at the problem and to work out what legislative changes, if any, are necessary in the tip income reporting requirements. In 1980, your committee wisely decided that no changes in the law were required.

Mr. Chairman, the IRS argues that there is substantial non-compliance. Yet it offers no support for this allegation. Furthermore, in the past two year, it has not provided any rationale or data to support its proposals. One final point is in order. Whenever the IRS talks about changing the rules for tipped employees, it uses as an example a waiter at a fine, high priced restaurant who when combining his salary and tips is earning a reasonably decent living. It is high time that the IRS recognized that the small handful of gratuity employees so situated. Unfortunately, is a miniscule percentage of the food service employees in the United States. This committee has twice reaffirmed the position that reinforces the original intent of the law passed in 1965. Simple equity and justice still supports a decision.

The task facing this great committee is awesome. Seldom in our recent past has there been so many economic concerns manifesting themselves at the same time. We did not mean to dwell on the charged tips provision, since it is not contained in your bill, but we are concerned that some will raise this issue as though it is the panacea for all our economic problems. Thus we cannot remain mute on this point.

Since we have had the privilege of working with the chairman and this distinguished committee in the past, we stand ready to assist you in any way possible to pass meaningful tax legislation. Any action you may take which stimulates the economy will benefit our members and the entire tourism industry in a positive way. Our members, as well as all of the citizens of this great country, are looking to you for guidance and help. I know you will not disappoint them.

We thank you for the opportunity to submit testimony before this distinguished committee.

STATEMENT OF THEODORE BERNSTEIN, DIRECTOR, INTERNATIONAL LADIES' GARMENT WORKERS' UNION RETIREMENT FUND

The ILGWU National Retirement Fund, a multiemployer pension trust, currently pays monthly pension benefits to over 112,000 garment workers and their survivors. The average present age of this group is 72.5 years and the average pension is but $112.50 per month. At this time, the average earnings of prospective retirees is approximately five and one-half dollars per hour. Obviously, this group of retirees and potential beneficiaries has limited savings and outside income and, therefore, would generally have minimal tax liability, if any at all.

The adverse consequences of the proposed change in the existing voluntary income tax withholding procedure far outweigh any beneficial effects. In fact, the change in procedure, while generating insignificant additional tax revenue, would create substantial administrative burdens and costs to the pension fund, not to speak of the undue hardship and confusion for this elderly group of citizens. The shifting from a voluntary withholding system to a complex system of electing out of withholding requirements creates an unfair burden and a gratuitous aura of uncertainty for unsophisticated pensioners. A sophisticated taxpayer avoids withholding merely by electing out, while the absence of affirmative understanding and action on the part of elderly pensioners could, under the new system, result in an unwarranted and unnecessary reduction of vital monthly income. Additionally, the huge administrative burdens and costs flowing from the implementation and maintainance of a mandatory election procedure would further reduce the limited dollars available for benefits under a pension plan which is compelled to pay benefit levels far below existing needs.

While we firmly oppose a mandatory election procedure, if new rules are to be adopted, at the very least, a reasonable dollar threshhold should be included. Certainly, where pension income is at a $1350 annual level, the additional tax revenue generated, if any, would be de minimus. The "improved compliance", rather than enhancing tax collection, would result in unnecessary sacrifices by those citizens least able to afford the consequences of this proposal and, again, exempt the "have's" and their interest and dividend income from shouldering a fair share of the tax burdens of our nation. This proposal represents a further cruel blow to a group of citizens whose confidence and security has already been severely shaken by the attacks on the Social Security system.

We urge that the concept of electing out of withholding requirements be eliminated with respect to the pension benefits of low income retirees.

INGAA

JEROME J. McGRATH
President
1660 L Street, N.W.
Washington, D.C. 20036

John H. Cheatham, III
Vice President, General Counsel
and Secretary
1660 L Street, N.W.
Washington, D.C. 20036

R. S. McKEE
Treasurer
P.O. Box 1396
Houston, Texas 77001

EXECUTIVE COMMITTEE

ARTHUR R. SEDER, JR.
Chairman of the Board
One Woodward Avenue
Detroit, Michigan 48226

PETER S. SMITH
Vice Chairman
P.O. Box 2563
Birmingham, Alabama 35202

FRANK E. NADER
3800 Frederica Street
Owensboro, Kentucky 42301

PETER J. KING, JR.
P.O. Box 1087
Colorado Springs, Colorado 80944

GEORGE L. MORROW
122 South Michigan Avenue
Chicago, Illinois 60603

COMMITTEE ON
RECEIVED
MAY 25 1982
WAYS AND MEANS

May 21, 1982

Honorable Daniel Rostenkowski
Chairman, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: H.R. 6300, a Bill To Improve Compliance with the Internal Revenue Laws.

Dear Congressman Rostenkowski:

The Interstate Natural Gas Association of America (INGAA) is a non-profit trade association whose membership includes virtually all of the long distance gas transmission companies subject to the jurisdiction of the Federal Energy Regulatory Commission. INGAA supports any reasonable means for improving the compliance with internal revenue laws by all taxpayers. Our members are concerned, however, that the proposed legislation would not result in fair and equitable treatment under those laws. INGAA, therefore, submits the following comments on the above proposal. We request that our comments be made a part of the record of the Committee on Ways and Means.

Nondeductible Interest Surcharge for Substantial Understatement

The addition of Code Section 6660, imposing a no-fault, nondeductible interest surcharge on a "substantial understatement" of income tax, will result in a discriminatory penalty on large corporate taxpayers, tend to discourage the use of normal appeal and settlement procedures and result in an increase in the case load of the Court of Claims and District Courts.

Although the Service has a published goal to complete examination of corporate income tax returns within a reasonable period of time, the examinations of INGAA member companies are not normally initiated within the guideline period. In almost all cases it has been necessary for the Service to solicit waivers of the statute of limitations to complete field examinations. Further, due to the complexities of the technical issues and the magnitude of the resulting tax, it is not uncommon for the final settlement to occur eight to ten years following the filing date.

Any no-fault interest surcharge penalty imposed on our members will be several times as large as the current statutory penalty for negligence and in some cases, may approach or exceed the amount which would result if a fraud penalty were applicable.

The imposition of this penalty places an undue burden on "large case" corporate taxpayers such as our members who make a conscientious effort to comply with the tax laws, but who are subsequently thwarted in this effort by changes in the position of the I.R.S. resulting from the issued rulings, regulations and court cases.

Although the proposed statute provides that the Secretary may waive the interest surcharge if the taxpayer can show there was a reasonable basis for understatement, in practice, such discretionary power can be used as a settlement leverage.

We strongly oppose the no-fault interest surcharges penalty provision and urge that it be removed because of its unreasonableness when balanced against other penalty provisions of the statute.

If this penalty provision cannot be eliminated, we suggest that language be added which will provide for an automatic waiver of the no-fault interest surcharge in the event an extension of assessment period by agreement under Section 6501(c)(4) of the Internal Revenue Code is granted. Because there are reasonable bases for differences of interpretation, a definition of "understatement of tax" should be supplied which endeavors to exclude understatements caused by legitimate technical disputes.

Restrictions on Payment of Interest on Certain Refunds, Etc.

The proposed change relating to the computation of interest, on overpayment resulting from net operating loss carry back, net capital loss carry back and credit carry back, (using the loss return filing date as opposed to the close of the year) will encourage the filing of hastily prepared returns which, although in processible form, would not be prepared with usual professional standards due to time pressure to recover the tax. We strongly urge that the change as to the date the overpayment is deemed to occur for purposes of interest computation relating to those carry back areas not be adopted.

We appreciate this opportunity to make our views known to the Committee in its deliberation of the merits of these issues.

Respectfully submitted,

Jerome J McGrath

Jerome J. McGrath
President

JJM:jj

Statement of Investment Company Institute

The Investment Company Institute respectfully submits this statement in connection with the consideration by the Committee on Ways and Means of H.R. 6300, the "Tax Compliance Act of 1982."

The Institute is the national association of the mutual fund industry. Its membership includes more than 600 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. The Institute's mutual fund members have assets of more than $225 billion, and have approximately 18 million shareholder accounts.

Mutual funds are designed to permit thousands of investors to pool their resources as shareholders in a fund which in turn invests in a large number of stocks or debt instruments under the supervision of a professional investment adviser. Mutual funds provide an economical way by which investors can obtain professional advice and diversification of investments. The shareholders of the fund are the owners and are entitled to all of the fund's net income, which consists of dividends, interest and net capital gains generated by the fund's investment, less the fund's operating expenses, such as investment advisory, custodial and accounting fees.

The mutual fund industry is most anxious to assist in the improvement of the operation of the internal revenue system. It should be noted that the changes contemplated by both H.R. 5829 and H.R. 6300 would require administrative costs and burdens for our industry. We would hope the Congress would not impose these burdens unless and until it can be assured that meaningful additional revenues will result. Assuming that the proposed measures to improve the system are not unduly expensive or impractical in the light of available equipment and personnel, the Institute will endeavor to give full support in this important effort.

BACKUP WITHHOLDING

For the reasons set forth in our testimony before the Committee on March 30, 1982, the Institute opposed the Treasury's proposal to withhold tax generally on payments of dividends and interest. However, the Institute testified in support of the proposal in H.R. 5829 (introduced March 15, 1982 by Congressman Conable) to require withholding on dividends and interest when payees have not furnished to payors the required taxpayer identification number, or when the Commissioner has notified the payors and payees that the number is incorrect. The Institute also supports the provisions of section 213 of H.R. 6300, which would provide a similar requirement (referred to in the bill as "backup withholding").

The mutual funds have endeavored diligently to obtain taxpayer identification numbers from their shareholders. An informal study by the Institute indicates that the percentage of mutual fund shareholders accounts without taxpayer identification numbers is in the neighborhood of 4 percent. We have not learned of any instance in which it has exceeded approximately 6 percent. The requirement of withholding from those persons who do not furnish the required taxpayer identification numbers should serve to reduce this small number significantly.

The Institute does wish to call to the attention of the Committee several important matters in connection with the proposal to withhold where taxpayer identification numbers are not furnished or are incorrect. First, it is essential that sufficient lead time be provided for mutual fund payors to gear up their equipment and personnel to handle the new withholding. Both H.R. 6300 and H.R. 5829 provide that the new withholding would go into effect with respect to payments made after December 31, 1983. The Institute believes that the December 31, 1983 date should provide adequate lead time. However, it is important that the necessary regulations and instructions, which the statute would leave to be developed by the Service and the Treasury, be finalized well in advance of the December 31, 1983 date, in order to permit payors to provide the necessary computer programming, equipment changes, instructions to personnel and notices to shareholders to conform to the new requirements. The Institute is mindful of the heavy burden that will fall upon the Service and the Treasury with their limited personnel to prescribe the necessary rules, but the Institute emphasizes the importance of consultation between government personnel and industry personnel to produce feasible rules. The mutual fund industry will be pleased to participate in those consultations.

Second, the Institute is concerned about the procedures to be followed by payors upon receipt of notification from the Commissioner that the payee has furnished an incorrect taxpayer identification number. Obviously, errors in the 9-digit numbers can occur for a variety of reasons, and withholding should not be invoked unless the payee has been notified and given an opportunity to make a correction. The Institute assumes that H.R. 6300 intends to provide for these circumstances through the proposed new Internal Revenue Code section 3402(s)(5)(F), which states that "The Secretary shall prescribe regulations for exemptions from the tax imposed by paragraph (1) during periods during which a person is waiting for receipt of a taxpayer identification number." The words "waiting for receipt of a taxpayer identification number" might be deemed to apply only to cases in which no number has previously been furnished. The Institute suggests that the language should be expanded to cover the circumstance in which the payor is awaiting a correction of a taxpayer identification number previously furnished.

Third, the Institute notes that under proposed section 3042(s)(5)(C) backup withholding would not apply to payments made to certain types of payees, including "an organization which is exempt from taxation under section 501." Mutual funds have many shareholders which are exempt from tax under section 501(a), including charities, educational institutions, pension and profit sharing plans, etc. Mutual funds and other payors will not be in a position to determine whether or not payees which have not furnished taxpayer identification numbers are in fact exempt from tax under section 501(a). Some provisions should be made to protect a payor from claims by payees who have not furnished the required numbers, or have furnished incorrect numbers, but who are in fact exempt from tax under section 501(a). One method of accomplishing that result would be to provide that the payee will be exempt from withholding where no number is furnished (or no correction of an incorrect number is made) only if the payee notifies the payor that it is exempt from withholding, and authorizes the payor to rely upon the exemption claim so furnished. The procedures for the handling of a significant number of exemption certificates must be simplified; otherwise the expense of withholding will mount significantly.

Finally, because of the interrelationship of the backup withholding requirement to the provisions relating to information returns of brokers, it seems possible that under certain circumstances backup withholding might be required on amounts distributed because of a redemption of shares of a mutual fund where the payee has not furnished a taxpayer identification number. A requirement of withholding of 10 percent could be a significant penalty because the redemption may not involve any taxable gain whatsoever to the shareholder and, indeed, could produce a loss. A withholding of 10 percent of the redemption proceeds would have no relationship to the amount of gain, if any. At least in the early stages of the institution of the backup withholding procedures, the Institute believes it should be sufficient to require backup withholding only with respect to dividends and interest, and to defer action on withholding on stock redemptions or other capital gain transactions until there has been adequate experience with backup withholding on dividends and interest. It may well be that backup withholding on dividends and interest will eliminate a high proportion of the cases in which no taxpayer identification numbers have been furnished.

INFORMATION RETURNS OF BROKERS

Section 202 of H.R. 6300 would amend Internal Revenue Code section 6045 to authorize the Service to require information returns to be filed by a "broker" with respect to transactions that he handles for customers. The term "broker" is defined broadly to include not only dealers but also "any other person who (for a profit) regularly acts as a middleman with respect to property transactions." This provision is sufficiently broad that it will encompass in many cases persons who handle the redemption of shares of mutual funds submitted for redemption by the owners.

The proposed statute would authorize the Secretary to require brokers to file information returns "with such details regarding gross proceeds and such other information as the Secretary may by forms or regulations require." The Institute believes that the mutual funds would be able to furnish, if given sufficient lead time, information regarding the gross proceeds paid out to shareholders submitting shares for redemption, but it would not be feasible for the mutual funds to furnish information as to the shareholder's cost or other tax basis for the shares redeemed, nor for the gain or loss realized by the shareholder on the transaction.

We understand some consideration has been given to requiring that the broker deliver to the customer a transcript of his account for all transactions occurring within the calendar year. We do not believe this would be feasible for mutual funds to furnish, particularly with existing equipment. We find, for example, that some of the mutual funds having advanced electronic equipment can furnish a transcript only for the last 13 or 16 transactions in the account. Where shareholders make monthly purchases of shares and have regular dividends reinvested, even this advanced equipment would not supply a transcript of all transactions in the account from January 1 through December 31.

We would call to the Committee's attention that redemptions of shares of money market mutual funds produce neither gain nor loss to the owners because the value of the shares remains constant. The assets of these companies are invested solely in short-term debt instruments, and all net proceeds of the funds are distributed periodically to shareholders as dividends, which are reported to the Service on Form 1099. Thus, the filing of information returns regarding redemptions by shareholders in the case of money market mutual funds would serve no useful purpose, since they involve neither gain nor loss to the owner. The total redemptions of shares in money market mutual funds in 1981 amounted to some $347 billion, resulting from millions of independent transactions. Information returns covering those transactions would merely add to the paperwork burden for payors and the Service alike without any benefit and should not be required.

The Institute notes that these provisions for information returns by brokers provide that the regulation can apply to payments made on or after January 1, 1983. The Institute would emphasize the need for sufficient lead time to permit the preparation of new computer programs and the instruction of personnel to comply with the regulations after they have been formulated.

WITHHOLDING ON RETIREMENT PLAN DISTRIBUTIONS

Both H.R. 6300 and H.R. 5829 would establish a system of withholding on pension annuities and other pension plan distributions. Pensioners would be allowed to elect not to have withholding apply. However, absent such an election, pensioners would be subject to withholding.

The funds of many pension and retirement plans are invested in shares of mutual funds. The Institute is concerned that such a program for withholding on pension benefits may be too burdensome on our nation's elderly citizens and that such an election procedure may be unduly costly and confusing.

The proposal would apparently require that pensioners would have to file with payors claims for allowance of personal and other exemptions from withholding similar to those used in connection with wage and salary withholding, or else would have to file with payors elections to have no withholding. It would doubtless prove difficult in some instances, because of infirmities or illnesses of the elderly and the difficulty of communicating with them, to secure the necessary documents from pensioners, thus leading to the necessity for excessive withholding without any allowance even for personal exemptions.

The Institute believes that it is important to avoid burdensome requirements with respect to periodic distributions that might lead employers to require lump sum distributions in order to avoid the administrative difficulties attendant upon periodic distributions. The continued maintenance of periodic distributions is a highly important aspect of private retirement programs.

Moreover, we do not believe that this contemplated change, which may have drastic effects on our country's elderly population, has as yet been given sufficient study and independent scrutiny. We therefore oppose enactment of these provisions at this time.

INDIVIDUAL RETIREMENT ACCOUNTS

The Institute estimates that some 1.2 million individual retirement accounts ("IRAs") are funded with mutual fund shares. Thus, the industry has a keen interest in any modifications to the current Code provisions relating to IRAs. Section 311 of H.R. 6300 provides for an increase in the rate of excise tax on early distributions from IRAs from 10 percent to 15 percent. The excise tax was originally imposed to discourage early withdrawals and to insure that IRAs are used for retirement purposes. The Institute believes that the present 10 percent excise tax, when added to the income tax that the individual must pay on the amount withdrawn, operates as a sufficient ban against possible abuse.

Presumably, taxpayers only withdraw funds from the IRAs prematurely to meet some unexpected financial need, such as a medical emergency. The imposition of an additional 5 percent excise tax would substantially increase the taxpayer's financial burden and would add to the financial hardship of an already needy individual. Moreover, the excise tax, being a flat percentage applied to the gross amount withdrawn, bears with unnecessary harshness upon persons who will owe little or no income tax on the amount withdrawn. Therefore, the Institute strongly opposes this provision.

Section 312 of H.R. 6300 provides tax-free treatment for partial rollovers of IRA distributions. The Institute supports this provision. Currently distributions from qualified plans are eligible for tax-free rollover treatment to the extent of an amount so transferred. We see no reason why IRA participants should not be treated equally.

The mutual fund industry will be pleased to meet at any time with the staff of the Committee and offer its assistance in the continuing effort to improve compliance with the internal revenue laws.

[Telegram]

ZURICH, SWITZERLAND, *June 4, 1982.*

JOHN SALMON,
Chief Counsel, House Ways and Means Committee,
Washington, D.C.

DEAR SIR: I herewith request the inclusion in the printed record concerning H.R. 6300 of the following comments which are mine and do not necessarily represent those of any of the organizations with which I am affiliated.

I am a certified public accountant and tax consultant who has worked in Zurich, Switzerland, since 1972. I served as president of the American Club of Zurich, president of the National Association of Accountants (Swiss chapter), a director of the Swiss-American Chamber of Commerce, and chairman of the Tax Committee of EUROMED (American Chambers of Commerce in Europe and the Mediterranean).

I herewith respectfully request that title IV of H.R. 6300 (Tax Compliance Act of 1982) which relates to transactions outside the United States be separated from H.R.6300 and be dealt with at another time, the reason being that I believe that adequate notice was not given from the date of introduction of the bill May 6, 1982, to enable constructive and meaningful comments at the hearing held May 18, 1982. I have reviewed copies of all testimonies presented and do not find that appropriate attention was given to title IV.

As I understand it, most testimonies given regarding H.R. 6300 were based upon testimonies previously given before Senate hearings at which there was no part dealing with international transactions. At this time I would just like to register a general feeling of dissatisfaction with title IV. I do think it would do more harm than good by establishing a second and lower class of U.S. citizen just because he is residing overseas. There would be presumptions that he or she is a criminal, or guilty until proven innocent, and force overseas taxpayers to meet a much higher standard of proof than taxpayers.

STEVEN E. KRAFT.

MACHINERY and ALLIED PRODUCTS INSTITUTE
1200 EIGHTEENTH STREET, N.W. WASHINGTON, D.C. 20036 202-331-8430

PRESIDENT
CHARLES W. STEWART

VICE PRESIDENT AND TREASURER
THOMAS F. RUSSELL .... Chairman
Federal-Mogul Corporation, Detroit, Michigan

VICE PRESIDENTS
JOSEPH A. BOYD .... Chairman
Harris Corporation, Melbourne, Florida
DAVID T. KIMBALL .... President
General Signal Corporation, Stamford, Connecticut

SENIOR VICE PRESIDENT
CHARLES I. DERR

VICE PRESIDENT AND CHIEF ECONOMIST
RICHARD E. [illegible]

SECRETARY
FRANCIS W. HOLAHAN, JR.

ASSISTANT TO THE PRESIDENT
FRED E. SHAND

STAFF DIRECTOR—INTERNATIONAL
PAUL H. PRATT

STAFF COUNSEL
WILLIAM J. HEALEY, JR.
DONN R. MARSTON

ECONOMIST
A. B. van der VOORT

ASSISTANT TREASURER
MILDRED A. SMITH

EXECUTIVE COMMITTEE
WILLIAM F. ANDREWS ... Chmn. and Pres.
Scovill Inc., Waterbury, Connecticut
BERNARD J. BANNAN .... Chairman
Western Gear Corporation, Lynwood, California
JAMES F. BERE .... Chairman
Borg-Warner Corporation, Chicago, Illinois
JOSEPH D. BRENNER .... Chairman
AMP Incorporated, Harrisburg, Pennsylvania
E. PAUL CASEY .... President
Ex-Cell-O Corporation, Troy, Michigan
ROBERT CIZIK .... President
Cooper Industries, Inc., Houston, Texas
W. PAUL COOPER .... Chairman
Acme-Cleveland Corporation, Cleveland, Ohio
HENRY A. CORREA .... Vice Chairman
ACF Industries, Incorporated, New York, New York
CLARK DAUGHERTY .... Chairman
Duracell International Inc., Vero Beach, Florida
E. M. de WINDT .... Chairman
Eaton Corporation, Cleveland, Ohio
EVANS W. ERIKSON .... Chairman
Sundstrand Corporation, Rockford, Illinois
EDMUND B. FITZGERALD .... President
Northern Telecom Inc., Nashville, Tennessee
T. MITCHELL FORD .... Chmn. and Pres.
Emhart Corporation, Hartford, Connecticut
JAMES A. D. GEIER .... Chmn. and Pres.
Cincinnati Milacron Inc., Cincinnati, Ohio
WARREN J. HAYFORD .... President
International Harvester Company, Chicago, Illinois
THOMAS A. HOLMES .... Chairman
Ingersoll-Rand Company, Woodcliff Lake, New Jersey
LEON C. HOLT, JR. .... Vice Chairman
Air Products and Chemicals, Inc., Allentown, Penn.
JOHN V. JAMES .... Chairman
Dresser Industries, Inc., Dallas, Texas
ROBERT V. KRIKORIAN .... Chairman
Rexnord Inc., Milwaukee, Wisconsin
J. PAUL LYET .... Chairman
Sperry Corporation, New York, New York
ROBERT H. MALOTT .... Chairman
FMC Corporation, Chicago, Illinois
QUENTIN C. McKENNA .... President
Kennametal Inc., Latrobe, Pennsylvania
DONALD R. MELVILLE .... President
Norton Company, Worcester, Massachusetts
GERALD B. MITCHELL .... Chairman
Dana Corporation, Toledo, Ohio
ALFRED G. MUGFORD .... Exec. Vice Pres.
White Consolidated Industries, Inc., Cleveland, Ohio
ELBERT H. NEESE .... Chmn. and Pres.
Beloit Corporation, Beloit, Wisconsin
JOHN R. PARKER .... President
A. O. Smith Corporation, Milwaukee, Wisconsin
BERT E. PHILLIPS .... Chairman
Clark Equipment Company, Buchanan, Michigan
ARTHUR J. SANTRY, JR. .... President
Combustion Engineering, Inc., Stamford, Connecticut
HENRY D. SHARPE, JR. .... Chairman
Brown & Sharpe Mfg. Co., N. Kingstown, Rhode Island
CRAIG R. SMITH .... President
Industrial Group, Bendix Corporation, Cleveland, Ohio
RICHARD B. STONER .... Vice Chairman
Cummins Engine Company, Inc., Columbus, Indiana
WILLIAM G. vonBERG .... Chairman
Sybron Corporation, Rochester, New York
R. J. WEAN, JR. .... Chmn. and Pres.
Wean United, Inc., Pittsburgh, Pennsylvania
JAMES W. WILCOCK .... Chmn. and Pres.
Joy Manufacturing Company, Pittsburgh, Pennsylvania
JOHN A. YOUNG .... President
Hewlett-Packard Company, Palo Alto, California

May 21, 1982

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman and Members
of the Committee:

Proposed Tax Compliance Legislation:
H.R. 6300 and H.R. 5829

The Machinery and Allied Products Institute (MAPI) is pleased to have this opportunity to comment for the public record of the Committee on Ways and Means concerning H.R. 6300, the proposed "Tax Compliance Act of 1982" sponsored by Chairman Rostenkowski, and H.R. 5829, the proposed "Taxpayer Compliance Improvement Act of 1982" sponsored by Congressman Barber B. Conable. Although the bills are not identical, they constitute "omnibus" efforts to overhaul provisions of the Internal Revenue Code with respect to such matters as information reporting, withholding (to a limited extent), enforcement measures, access to books and records, penalties, audit authority, and administration, all with a view toward reducing a "compliance gap" estimated by some parties to be on the order of $100 billion per annum.

MAPI's interest in this proceeding is a direct one, both as national spokesman for the capital goods and allied product industries, and as a "citizen" otherwise normally interested in the cost-effective functioning of a governmental activity. In times such as these, characterized by serious current and projected federal budgetary deficits unless corrective measures are taken, all reasonable options should be explored for eliminating unnecessary spending and improving the collection of revenues. As to the revenues, we find it understandable that so much attention is being given to compliance improvement considering that the alternative is to increase the tax burden on persons already paying their "fair share" and thereby to countermand to

MACHINERY & ALLIED PRODUCTS INSTITUTE AND ITS AFFILIATED ORGANIZATION, COUNCIL FOR TECHNOLOGICAL ADVANCEMENT, ARE ENGAGED IN RESEARCH IN THE ECONOMICS OF CAPITAL GOODS (THE FACILITIES OF PRODUCTION, DISTRIBUTION, TRANSPORTATION, COMMUNICATION AND COMMERCE) IN ADVANCING THE TECHNOLOGY AND FURTHERING THE ECONOMIC PROGRESS OF THE UNITED STATES

some extent the beneficial tax revisions enacted earlier in the 97th Congress. On the other hand, we hasten to add that the task before the Committee is delicate because the success of the self-assessment concept underlying the U.S. federal income tax is in no small way dependent upon taxpayers' perceptions as to the fairness of the system overall and in every detail affecting them.

In general, MAPI agrees with the premise of both H.R. 6300 and H.R. 5829 that taxpayers should pay the government all amounts clearly owed and do so as promptly as circumstances will allow. However, the instruments of compliance, collection, and enforcement should not ask more of persons than can reasonably be expected, and should neither abridge their rights nor operate to intimidate them in their determinations where honest disagreements may exist. This implies the need for a close examination of all the costs and benefits of proposals under study, including attention not only to estimates of additional collectible revenues but also to paperwork burden, system complexity, the subjective considerations referred to earlier, potential interference with normal business activities, and other factors. We further urge the Committee to recognize that there will be slippage in tax compliance in the best of circumstances, and that radical changes in the compliance apparatus could have unexpected, counterproductive results.

Our more specific comments set forth in the remainder of this letter follow the outline of H.R. 6300 because it is more "comprehensive" than H.R. 5829, and we will refer to parts of the latter bill in context. We do not have views to express at this time on each provision of each bill, but this should not be construed as either approval or disinterest. To summarize our thoughts--

1. The registration provisions for debt instruments in Section 102 of H.R. 6300 are too broad and could unintentionally impair the operations of legitimate capital markets.

2. The civil penalty applicable to persons involved with documents leading to false returns, Section 122 of H.R. 6300, is an improvement on Section 121 of H.R. 5829 but is too sweeping in its coverage and would be an unnecessary appendage to the existing criminal penalty.

3. The information reporting provisions of both bills (Sections 201-205 of H.R. 6300 and Sections 101(a) and (b), 102, and 103 of H.R. 5829), although more desirable under the circumstances than withholding alternatives that have been examined, need further study to assure cost-effectiveness before any rules are imposed.

4. The withholding items, Sections 213 and 301 of H.R. 6300 and Sections 124(c) and 131 of H.R. 5829, strike us as being backdoor attempts to initiate withholding on a broader scale, and we are not convinced that the proposals for withholding on pensions and annuities would be a "favor" to the elderly.

5. Considering that IRS burdens the average individual with far more paperwork than any other single bureau of the federal government, we disagree with Section 215 of H.R. 6300 and Section 202 of H.R. 5829 in their effort to relieve IRS from virtually all responsibility to the Office of Management and Budget.

6. We are concerned about Sections 402 and 411 of H.R. 6300 dealing with foreign transactions because the books and records provisions are unduly harsh and the penalty provision is unnecessary.

7. We oppose the daily compounding provision of Section 501 of H.R. 6300 for interest, but find acceptable the semi-annual compounding and determination items of Sections 111 and 112 of H.R. 5829.

8. We oppose on grounds of fairness parts of Section 502 of H.R. 6300 and Section 133 of H.R. 5829 regarding restrictions on payment of interest on certain refunds, and consider them without much justification if the interest determination rules are to be changed to a more current basis.

9. The substantial underpayment penalty of Section 503 of H.R. 6300 improves on its counterpart, Section 125 of H.R. 5829, but still "tips the scales" in favor of IRS in a manner that may seem unfair to taxpayers who, through no fault of their own and no improper purpose, have committed error.

More Detailed Comments

Debt Registration

H.R. 6300 (Section 102) would deny certain tax benefits with respect to the issuance of bearer instruments to the general public, and would prohibit the issuance of bearer obligations by the federal government. Specifically, every obligation of the United States or any agency or instrumentality thereof would have to be in registered form. Also, interest on an obligation of a state or local government would not be exempt from federal income tax unless the obligation were issued in registered form. In the case of obligations issued by other than governmental units, registration would be required on all obligations except those (1) issued by a natural person, (2) not of a type offered to the public, and (3) having a maturity at issuance of less than one year. IRS would be authorized to require registration of short-term and non-public debt instruments if they were determined to be used frequently to evade federal taxes.

The tax benefits denied would be deductions for interest paid and loss deductions on affected obligations. The new registration requirements would apply to obligations issued after December 31, 1982.

H.R. 5829 contains no comparable provision.

Comment.--We note that the Administration is enthusiastic about the registration requirement of H.R. 6300 because of tax evasion in the illegal sector using bearer obligations. At the same time, Treasury feels that it is important to be certain that legitimate markets not have their operations impaired by the registration requirement. In that regard, we have been informed by member companies of the Institute that the registration requirement would interfere with Eurodollar debt offerings by U.S.-based companies because such debt instruments customarily are marketed in bearer form. In our opinion, it is most important that we maintain unimpeded access to the Eurodollar capital market. An exception of some sort would appear to be the least that is in order.

On an item of lesser importance, we note in Treasury's testimony on H.R. 6300 an effort to "brush aside" or minimize the paperwork burden of registration. At one point, for example, Treasury contends that "many" issuers of obligations prefer a registration system because it reduces insurance and handling expenses, even though some expense may be involved in recording ownership of obligations. Treasury also alleges that the slightly lower trading price of registered bonds may well be due to the decreased value of these instruments in the illegal sector. Our information is to the contrary, in that the costs of registering debt instruments of the conventional type are not equaled by the insurance and handling costs associated with bearer obligations. In addition, we have always understood the lower market value of registered bonds to be directly related to the administrative burden of changing registration.

We agree with Treasury's objection to the provision of H.R. 6300 that would override the many tax treaties that have been negotiated on the basis of a mutual interest exemption. Treaty negotiations yield a delicate composite of benefits and concessions which, in our opinion, should not be upset unilaterally by an Act of Congress under circumstances such as these.

Civil Fraud Penalty

H.R. 6300 (Section 122) would provide for a new civil penalty on any person who aids, assists in, procures, or advises, the preparation or presentation of a return, affidavit, claim, or other document under the Internal Revenue laws which the person knows will likely be used in connection with any matter arising under the tax laws, and which the person knows will (if used) result in an understatement of the tax liability of another person. The penalty, which would be $1,000 for each return or other document ($5,000 in the case of returns and documents relating to the taxes of a corporation) could be imposed whether or not the taxpayer knew of the understatements. The return preparer penalties generally would not apply if the new penalty is imposed. However, the new penalty would apply in addition to all other penalties provided by law. The burden of proof in imposing the penalty would be on IRS, and the penalty would be effective beginning on the day after the date of enactment.

The parallel provision of H.R. 5829 (Section 121) differs in that it is (1) narrower than that of H.R. 6300 in applying only to acts of corporate directors, officers, employees, and advisors that affect the corporation's tax, and (2) broader than that of H.R. 6300 in applying to any fraud that results in an understatement of the corporate tax. The penalty provision of H.R. 5829 does not require that the fraud be connected to the presentation or preparation of a return or other document under the Internal Revenue laws. Also, the penalty is equal to 50 percent of any corporate underpayment that results from the fraud, up to a limit of $100,000 per participant.

Comment.--As is generally understood, current law provides a criminal penalty for willfully aiding, assisting in, procuring, counseling, or advising the preparation or presentation of a false or fraudulent return, affidavit, claim, or other document under the Internal Revenue laws. The penalty is a fine of up to $5,000 or three years imprisonment, or both. Other than for income tax return preparers, there is no comparable civil penalty on persons who aid or assist in the preparation or presentation of false or fraudulent documents.

Although the civil fraud provision of H.R. 6300 is intended to parallel closely the criminal sanction already in place, we question whether the new penalty is needed in view of the strong deterrent of fine and/or imprisonment that already exists. Tax fraud already is viewed as an extremely serious matter by corporate employees and their advisors, to whom the new penalty would appear mainly directed. We frankly do not know how added increments of "punishment," civil or criminal, could sensitize these individuals more to the gravity of the responsibilities that they bear. On the other hand, we can readily see that the extra "layering" of penalties would contribute to perceptions of heavy-handedness about government's administration of a system expected to function on a basis of voluntary self-assessment.

We are aware that a bar association suggested that a civil fraud penalty be added to the Internal Revenue Code to fill a "void." The "void" in question has been there for some time now, and is due not to inadvertence but to a conscious decision that existing penalties were sufficient. Let us add that the penalty provisions of the Internal Revenue Code were revamped as recently as the Economic Recovery Tax Act of 1981, signed into law on August 13, 1981. If "tidiness" is the principal purpose behind a complicated and largely unnecessary new penalty provision, then we submit that there is insufficient reason for Congress to proceed. It is noteworthy that both bills would deter individuals from taking responsible positions contrary to those of IRS where the law is not definitive, an effect that is not consistent with the spirit of the system or conducive to the orderly resolution of controverted policy issues.

On a matter of detail, we can anticipate that considerable dispute would revolve around the question of whether a person knowing that a document will likely be used in connection with any matter arising under the tax laws also knows that the document will (if used) result in an understatement of the tax liability of another person. Considering the complexity of the federal income tax law and the fact that honest disagreements exist between the tax collector and taxpayer in so many areas, virtually every proposed adjustment in the audit of a tax return would involve a case where the person associated with the document considered himself to be generating a correct statement of tax liability, whereas IRS clearly would consider it to be an understatement.

In our opinion, if there is to be a new civil fraud penalty, it should be clearly defined; narrowly focused; and applicable only to individuals directly responsible for documents used in the preparation of the tax return and directly engaged in tax fraud. On several other items, we believe that the penalties provided in H.R. 5829 would be extreme, and are not integrated properly with the tax return preparer penalty.

Information Reporting

The information reporting provisions of H.R. 6300 (Sections 201-205) would, to summarize, expand both the categories of interest specifically subject to the information reporting requirements and the categories of persons liable to report such interest; instruct IRS to prescribe new regulations for information reporting, at least with respect to security and commodities brokers and dealers, as soon as is practicable; provide a separate reporting requirement for payments to persons who are not employees; impose a new reporting requirement with respect to certain direct sales; require that information returns for state and local income tax refunds, credits, or offsets aggregating $10 or more, paid to any individual, be filed with IRS; and subject reimbursements for casualty and theft losses to the general information reporting at source requirements.

The reporting rules of H.R. 5829 cover certain of the same items, but do so differently and do not deal with some at all. Unlike H.R. 6300, H.R. 5829 contains an information reporting section for most employers who pay over to individual employees $600 or more of charged tips in any taxable year.

Comment.--We commend the authors of the bills for looking to enlarged information reporting rather than withholding, generally speaking, as a means for enhancing compliance. On the other hand, we hope that enthusiasm for the exercise will not generate a "paper blizzard" of a form and content that cannot be utilized by IRS or is misinterpreted by taxpayers who receive duplicate copies of the reports. For example, we currently are unaware of any feasible way for securities and commodities brokers to report transaction gains and losses meaningfully on a cost-effective basis. Without intending to suggest that this is impossible, we can at least conclude that there will be some serious impediments involving identification and matching, including questions of cost basis, where--to cite one example--securities or contracts are acquired one place and sold somewhere else. Also, one could expect some confusion where recipients of information returns concerning certain refunds and reimbursements are individuals who did not file itemized returns in the first instance.

Along the same lines, IRS states that it is able to perform document matching on a relatively high percentage of information returns received in machine processible form, but is not nearly so successful with paper reports. We doubt that significantly improved compliance will result from shipping to IRS more bales of paper that it is unable to process. Although information reporting is the way to go, it will not be feasible in every application.

Withholding

Several withholding provisions of H.R. 6300 are of concern to us. One of these (Section 213) would provide for withholding at the source at a tax rate of 10 percent if a taxpayer fails to supply a taxpayer identification number or supplies an incorrect one to another person who must file certain types of information returns with respect to payments to the taxpayer. Among the types of payments covered would be dividends, interest, payments from brokers and certain dealers, rents, salaries, wages, commissions, fees, other compensation for services, other fixed or determinable gains, profits, or income, and certain payments to independent contractors or by direct sellers. Another provision (Section 301) would establish a voluntary withholding system for pension payments, allowing individuals to "elect out," and IRS would be required to establish, by regulation, reporting and record-keeping requirements for pension distributions.

Somewhat different withholding items having a similar purpose are contained in H.R. 5829 (Sections 124(c) and 131). Our remarks are general in nature and, therefore, are addressed only to H.R. 6300 in the withholding context.

Comment.--We repeat that these seem to us to be backdoor attempts to initiate withholding on a broader scale than now is accomplished. As we read these proposals, nearly everyone paying any significant amount to anybody else would be required to withhold where the proper identifying number is not furnished. It seems clear to us that the costs of the exercise would far exceed the benefits. Furthermore, the "penalty" would fall not on the person who supplied the incorrect number but on the hapless payor who would be saddled with the unwanted task of withholding. Regarding pensions, annuities, and the elderly, many would not elect out simply because of the additional burden of doing so and, consequently, would be subject to withholding whether appropriate or not.

Having conceded the battle on withholding with respect to interest and dividends, Treasury now seems embarked on a circuitous route toward the same objective of enlarged withholding. We suggest that the Committee delete both withholding items from the bill for reasons already thoroughly discussed in prior public hearings.

Paperwork

Under identical sections of H.R. 6300 and H.R. 5829 (Section 215 and 202, respectively) the Paperwork Reduction Act of 1980 would not apply to any rule or regulation promulgated under the Internal Revenue Code or to any information collection request that the Treasury Secretary determines to be authorized by the Code or by any rule or regulation.

Comment.--As might be expected of an agency that once had free rein but now is held to account for the paperwork consequences of its actions, the Internal Revenue Service has been grousing about clearance through the Office of Management and Budget ever since enactment of the Paperwork Reduction Act of 1980. Ironically, IRS causes more paperwork burden for the average citizen than any other bureau at any level of government in the United States. In response, IRS contends that its work is too specialized to be subject to efficient review by OMB--a position with some merit that nonetheless fails to address the larger question. Treasury and IRS also argue that the clearance procedure inhibits their ability to pour out regulations at the desired pace, an assertion that speaks to the effectiveness of OMB in the role assigned to it under the Act.

We would be reluctant to see Congress change the OMB clearance procedure for IRS. As we understand the matter, there have been administrative accommodations between Treasury and OMB that honor the thrust of the Paperwork Reduction Act's provisions while still providing IRS with some latitude to move without oversight. In our opinion, Treasury should not be treated differently from other departments and agencies of the federal government beyond the administrative accommodations already referred to, and we feel that accountability to OMB imposes a management discipline that would not otherwise exist in the case of IRS.

Foreign Transactions

H.R. 6300 (Section 402) generally would restrict a taxpayer, who has refused to provide items of documentation of foreign transactions requested by IRS during audit, from using the requested documentation to prove his view of those transactions in court. Specifically, any court having jurisdiction over the issue would be required to prohibit the introduction by the taxpayer of any foreign-based documentation covered by a document request relating to the item unless the documentation was provided to IRS within the time provided in the bill. An exception would apply if the taxpayer established to the satisfaction of the court that the failure to provide the documentation when requested was due to reasonable cause. However, the fact that providing the information violated local law would not be treated as reasonable cause.

The bill also would create a presumption that any amount received from a foreign jurisdiction is income (rather than, for example, a loan) unless, upon request of the IRS, the recipient produces sufficient documentary evidence that establishes that the amount is not income. Likewise, there would be a presumption that any tax benefit purporting to arise in a foreign country would be denied unless, on request of IRS, sufficient documentary evidence were provided to establish the true nature of the transaction.

Another provision would state that, if the items concerning the admissibility of evidence or the presumptions about income or a tax benefit apply to a taxpayer because of a request for information arising out of any trade or business (or other activity) of the taxpayer, then IRS may require that the taxpayer maintain documentation for the trade or business in the United States at a place designated by IRS. This provision would not apply if a court determined that the taxpayer's failure to produce the requested information was due to reasonable cause. The rules in question would be effective for formal document requests mailed after the date of enactment.

Another section of H.R. 6300 (Section 411) would "simplify" the penalty for failure to furnish information with respect to a controlled foreign corporation by adding a fixed-dollar penalty for failure to furnish the required information. The penalty would be $1,000 for each such failure for each annual accounting period of the foreign corporation. If the failure continues for more than 90 days after notification by IRS, then there would be additional $1,000 penalties for each 30-day period (or fraction thereof) during which the taxpayer continues to fail to produce the requested information.

H.R. 5829 does not have similar provisions.

Comment.--We are concerned by the language pertaining to the admissibility of evidence because it could be construed to be in violation of the "due process" to which the taxpayer is constitutionally entitled. Also, the provision is extreme in giving no weight whatsoever to prohibitions of local law on providing the information as a factor in determining reasonable cause. We suggest that the Committee give further consideration to the legality of what has been proposed, and, under no circumstances, approve a provision treating foreign law as irrelevant. Also, there has been some question as to whether the language on access to books does not also apply to U.S.-based companies with minority interests abroad, and the Committee should at least consider limiting any such rules to companies with controlled foreign corporations inasmuch as minority shareholders rarely are in a position to obtain the sort of documentation that IRS might seek.

Regarding IRS authority to require that a taxpayer maintain documentation for a trade or business in the United States at a place designated by IRS, there is an "open" regulatory proceeding on this same subject in which MAPI and many other organizations have participated with written and/or oral comments. As implied by the legislation, a number of taxpayers questioned the authority of IRS to impose such a rule, although, as a practical matter, the ability of IRS to obtain the documentation it needs in most cases is not seriously in doubt. For the "recalcitrants" who might become subject to the IRS requirement, industry commentators generally sought some latitude as to the location; flexibility with respect to copies rather than original documents; and a shorter time period for maintenance of books in the United States.

Concerning the new penalty item, we cannot imagine why it would be needed when a penalty as severe as the foreign tax credit reduction is already in place. Further, we have been informed, contrary to information provided by Treasury, that the foreign tax credit penalty is not particularly difficult to invoke. Notwithstanding the foregoing, if the existing penalty is, in fact, not a useful compliance instrument, then we suggest that the Committee consider--as an alternative--that the new penalty be enacted and the existing one be repealed.

Compounding

Under H.R. 6300 (Section 501), all interest payable under the Internal Revenue Code would be compounded daily, and this requirement would apply beginning in 1983 to amounts remaining unpaid at the beginning of 1983 as well as all other interest accruing under the Internal Revenue laws after 1982. In contrast, H.R. 5829 (Sections 111 and 112) would require interest to be compounded semiannually, instead of daily, and interest rates would be determined semiannually based on the average adjusted prime rate charged by commercial banks during the six-month period ending September 30 (effective January 1 of the succeeding calendar year), and March 31 (effective July 1 of the same calendar year). The determination amendment would be effective for adjustments taking effect after December 31, 1982.

Comment.--In brief, we favor the two provisions of H.R. 5829 just mentioned. A semiannual determination would be less susceptible to the "highs" and "lows" to which the system now is subject for extended periods of time. Also, we concur in the observation that a simple interest computation has the effect of greatly understating the amount of interest due in the case of an underpayment or overpayment that is outstanding for several years. Although IRS can more easily administer daily compounding as compared to semiannual compounding, we support the latter because many taxpayers will find it easier to administer.

Refunds

Under H.R. 6300 (Section 502), no interest would be paid on a refund claimed on a late return if the refund is made within 90 days after the return is filed. Also, an overpayment resulting from a net operating loss carryback, a net capital loss carryback, or credit carryback (including a foreign tax carryback) would be treated as having occurred on the due date (with extensions) of the return for the year in which the carryback arose. For purposes of the payment of interest on overpayments, a return would not be treated as filed until it is filed in processible form. The provisions on late returns and processible returns would be effective for returns filed after the thirtieth day after the date of enactment. The provision regarding interest overpayments due to carrybacks would be applicable to interest accruing after enactment.

H.R. 5829 (Section 133) would provide that no interest is due on an overpayment for any period prior to the later of the filing of the return or the due date (without extensions). For refunds arising from net loss carrybacks, H.R. 5829 would deny interest for any period prior to the date the refund is claimed or otherwise applied for. The amendment to the interest rules would apply to payments of interest accruing after March 11, 1982 if those payments are made later than 30 days after enactment. H.R. 5829 would not change the interest rule for foreign tax credit carrybacks. Returns would not be treated as filed for purposes of the interest on refunds until they are processible.

Comment.--We doubt that there is any significant incidence of abuse where business taxpayers delay refund filings in order to take advantage of statutory interest rates. Also, we note that the study of this subject by the General Accounting Office identified this as a "potential" abuse. Whether it is potential or actual, it would seem to us that one way to deal with the matter would be to adjust interest rates more frequently so that statutory interest rates rarely, if ever, exceed for any period of time those which are available in the market. As previously indicated, we support the provision of H.R. 5829 which would provide semiannual interest determinations based on the average adjusted prime rate charged by commercial banks during specified six-month periods of time. In our opinion, to deny interest in many situations where there has been no abuse and where government has had the use of a taxpayer's funds would simply be unfair.

Substantial Understatement

H.R. 6300 (Section 503) would provide for a no-fault interest surcharge that would be nondeductible and payable because of any substantial understatement of tax. A substantial understatement would be one that is at least 10 percent of the taxpayer's actual tax liability and $5,000 or at least 50 percent of the actual tax liability and $500. In these cases, there would be an interest surcharge equal to 20 percent of the interest payable with respect to any underpayment due to the understatement. IRS could waive all or part of the surcharge if the taxpayer showed that there was a reasonable basis for the understatement and that the taxpayer acted in good faith. The surcharge would apply to returns due after December 31, 1982, but would not apply to that portion of an understatement subject to the Section 6659 valuation overstatement penalty.

H.R. 5829 (Section 125) contains a 10 percent penalty on substantial understatements. The penalty would apply only if the understatement arose out of items not disclosed on the taxpayer's return, and would be 10 percent of any underpayment of tax allocable to an undisclosed item from which a substantial understatement arose. For an individual, an understatement of tax liability would be substantial only if it exceeds the greater of $5,000 or 10 percent of the amount of tax required to be shown on the return. For corporations, the understatement would be substantial only if it exceeds $10,000 or 10 percent of the tax required to be shown on the return. This penalty would apply to an underpayment in addition to the negligence penalty but would not apply if the fraud penalty or the valuation overstatement penalty were imposed. Also, IRS would not be able to waive the penalty.

Comment.--Although we prefer the no-fault penalty of H.R. 6300 to the one contained in H.R. 5829, we are not confident that either one represents good policy from the standpoint of the vast majority of taxpayers that make reasonable attempts to report their liability accurately. We disagree with the implicit notion that the self-assessment federal income tax will operate acceptably well only if the Sword of Damocles hangs above each person assessing himself. While we are sympathic with the concern of IRS about those who would play the "audit lottery," we also feel that the Code contains adequate penalties to deal with persons who do not act in good faith. We hope that the Committee will recognize that a system of "voluntary" compliance resting mainly on threat may not be the most effective one, and does not in fact reflect the philosophy underlying our federal income tax law.

As already indicated, the penalty structure of the Internal Revenue Code was updated as part of the Economic Recovery Tax Act of 1981. We question whether it is necessary to visit this subject so often. Also, because the substantial underpayment penalty would be a significant departure in our tax law, it deserves closer scrutiny before any decisions are made.

Concluding Comment

It is clear to MAPI that the evaluation of tax compliance measures is being rushed. Although there is some urgency associated with reaching a budgetary compromise in order to reduce the burgeoning deficits, we urge that careful deliberation rather than precipitate action be taken with respect to compliance proposals. When S. 2198--the Senate companion bill to H.R. 5829--was introduced by Senator Dole, hearings were called on such short notice that very few interested parties had the opportunity to appear and comment. In the case of H.R. 6300, hearings were announced and then held so soon after introduction of the bill that many organizations did not have sufficient time to analyze and arrive at judgments with respect to the many sections contained therein. Considering that neither the estimated compliance gap nor the projected budgetary deficits would be significantly affected by the bills under consideration, we believe that the Committee should provide further opportunity for interested parties to present their views for the public record.

This concludes our comments on H.R. 6300 and H.R. 5829, and we trust that our views will be of use to the Committee.

Respectfully,

Charles Stewart

President

STATEMENT OF THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

The National Association of Independent Insurers (NAII) is in complete accord with Chairman Rostenkowski's statement in introducing H.R. 6300 on May 6, 1982, namely "that in the interest of fairness to the large number of taxpayers who do comply with the tax laws, every effort must be made to insure that our tax system is not undermined by the actions of a few who flaunt or otherwise ignore its rules."

However, NAII submits that the H.R. 6300 is substantially deficient in part, since it contains extensive provisions directed to independent contractors, and in particular, those engaged in direct sales while it contains no provisions regarding classification for tax purposes of those persons doing business as independent contractors.

In view of this, NAII opposes H.R. 6300 in this regard, and supports in lieu thereof the overall safe harbor, information and penalty provisions of the Gephardt/Conable Bill, H.R. 6311.

Further, the bill for the first time would subject reimbursements for casualty and theft losses to information return requirements, and in effect, equate such insurance payments to "compensation." NAII recommends the committee reject this provision (Sec. 205).

Also, NAII is concerned with the proposed restrictions on interest payments (Sec. 502) and opposes this action.

BACKGROUND OF NAII

NAII is a voluntary, insurance company trade organization consisting of more than 500 members. Companies, both members and subscribers, now affiliated with the organization total more than 600. Members range from small companies doing business in only one state to one of the largest multi-state writers; from the highly specialized writer of farmers or other consumer groups to the so-called full multiple-line insurer; and from those merchandising their insurance products through the mails to those using various agency systems. Virtually every state is represented in the membership.

CASUALTY REIMBURSEMENTS (SECTION 205 OF H.R. 6300)

Presently, there is no requirement that persons making payment to an insured for a casualty loss, file information returns regarding this payment with the IRS, nor that similar information be furnished to the insured.

For the first time such payments under the provisions of H.R. 6300, would be equated to "rent, salaries, wages, . . . compensations . . ." and similar payments. Insurance companies would be required to furnish to the IRS and policy holders (or to a third party) information returns regarding these payments.

In view of the administrative and cost/benefit problems arising out of Section 205, NAII and its member companies recommend that it be rejected and eliminated from the bill.

Each year millions of payments are made by our member companies to the insured because of casualty and theft losses. Since the bill requires reporting on an aggregate basis of $600 or more per year, each member company would be required to keep individual records for each insured to determine when all payments made during the year reached the $600 level and the appropriate returns would have to be made at considerable expense to insurance companies. This factor is fully recognized by the Treasury (see page 15 of Testimony of John E. Chapoton, Assistant Secretary, Department of Treasury) and consequently any consideration of Section 205 should be viewed in this regard.

All insured who receive aggregate payments of $600 or more would have to be notified with no distinction made on whether or not they itemized deductions for federal income tax purposes. We suggest the resulting confusion to the taxpayer would be horrendous. The natural inclination of the taxpayer in receiving an information return (Form 1099) for an otherwise non-taxable insurance payment would be to include this item erroneously in income.

The problem of requiring 1099 reporting with respect to casualty payments made by insurance companies to their policy holders is that it will not necessarily provide meaningful information to the IRS. Currently, deductions on casualty insurance coverages run as high as $400. Therefore, many insurers who receive reimbursements from insurance companies for casualty losses will still be entitled to claim casualty loss deductions on their tax returns to the extent their deductible exceeds $100.

In addition, by instituting a program in which non-income items are reported on 1099's, the IRS runs the risk of undercutting the integrity of Form 1099.

Presently, taxpayers receiving 1099's recognize that amounts reported on the Form constitutes income subject to tax. By requiring reporting of non-income items, taxpayers may no longer be certain that amounts reported on 1099's are includible in income. Accordingly, the confusion which results may have the effect of encouraging taxpayers to ignore 1099's entirely.

Also, with an estimated 16 million or more transactions required to be reported under this section, the usefulness of the information by the IRS in cost benefit situations appears to negate enactment of this burdensome requirement upon insurance companies. NAII has not had sufficient time since introduction of this bill to determine the cost to be incurred by our member companies in complying with the reporting requirements. It would appear that the estimated benefits to be derived would be far outweighed by the administrative difficulties and costs incurred. Actually, the problems of improper reporting regarding casualty and theft losses is an audit problem, not in information one and involves the difficulty resulting from a deduction in one year and reimbusement to the taxpayer in the following year. Thus, even with insurance information, the IRS must resort to audit in order to insure compliance.

BALANCED LEGISLATIVE APPROACH NECESSARY IN INDEPENDENT CONTRACTOR AREA

Section 203 of H.R. 6300 (and related penalty and backup withholding provisions) imposes separate reporting requirements for payments to persons who are not employees, i.e., independent contractors and specifically, imposes new reporting requirements with respect to so-called direct sales. These provisions generally apply to aggregate payments of $600 or more made to such persons by individuals or corporations engaged in a trade or business.

NAII, without question, supports the need for each taxpayer to carry his fair share of the tax burden and accordingly to pay his individual taxes. However, in achieving this worthwhile aim and recognizing the need to retain the integrity of our self-assessment system of taxation, NAII submits that any approach to the taxation of independent contractors should be on a comprehensive basis dealing in the overall with the substantive (classification), procedural and compliance issues on a federal income tax level.

Without a balanced approach, any additional reporting or penalty provisions imposed on independent contractors, and particularly as in H.R. 6300, the direct sellers must be considered to be discriminatory. Here also, the benefits derived by the IRS are far outweighed by the costs involved on industry in general.

It is important that those who are to comply with the law be assured of their status. Except for the freeze provisions of Section 530, such assurance does not now exist in the law for independent contractors. Thus, any compliance requirements should equitably be balanced with safe harbor provisions classifying independent contractors. If not, industry groups face the dilemma of on the one hand, implementing costly compliance provisions while on the other being told by the IRS all their "independent contractors" are employees.

CONCLUSION

In view of the foregoing, NAII strongly recommends deletion of Section 205 dealing with casualty reimbursements and appropriate consideration of the information, penalty and backup withholding provisions imposed on non-employees/independent contractors be accomplished only in a comprehensive manner as set forth in H.R. 6311.

One final observation is required in view of the comprehensive nature of H.R. 6300 in the compliance area. This proposal was just introduced on May 6th and contains broad sweeping revisions imposing new methods of approach in various areas of tax law. Its size alone of 142 pages of technical language reflects its overall nature. NAII agrees with the American Bar Association that more time is needed for appropriate technical consideration of such important legislation. The bill introduced on May 6th, with hearings scheduled for May 18th and announced May 7th, afforded just two weeks for the general public to review, digest and prepare adequate testimony on what appears to be legislation likely to be seriously considered this session. This is too short a time period for any industry group or taxpayer to give adequate consideration to each and every part of such an important and intricate piece of tax legislation. For example, Section 502, dealing with restrictions on interest payments involving credit and loss carryback refunds adversely impacts insurance companies, but NAII has not had sufficient time to take a considered position in this regard. Tentatively, we oppose such a move to deny interest payments on tax paid by taxpayers and available for use by the Treasury where it is found such tax was not due and owing. This is just one of the many provisions of H.R. 6300, which given adequate time, we would have liked to have had the opportunity to consider and comment on in order to assist the members of the Committee. However, in the future, we recommend that the general public be afforded sufficient time to consider and comment on such important legislation.

STATEMENT OF THE NATIONAL RESTAURANT ASSOCIATION

The National Restaurant Association is a non-profit trade association with headquarters in Washington, D.C. It offers programs in public affairs, education and research to its 10,000 members, who operate more than 100,000 food-service facilities.

The NRA appreciates the opportunity to comment on these compliance proposals, most particularly the one contained in H.R. 5829 requiring employers to report to the Internal Revenue Service tips received by each employee on credit card charge slips.

The IRS claims there is massive under-reporting of tips (though they have disclosed few solid facts to substantiate this claim) and that new compliance measures are necessary. Yet Internal Revenue Code Section 6001 already requires employers to retain charge receipts and statements of tip income made by employees. The agency has neglected to make us of this information over the years, and has yet to explore the possibilities of increasing collections by using this information to which it already has access.

This lack of effort on the part of IRS might not make much difference if the new reporting proposal was as simple as it may appear. But, in practice, the new reporting provisions would cause substantial difficulties for both employees and employers.

Tipped employees would have significant new paperwork problems. Under voluntary tip-pooling arrangements (which under law the employer cannot control), the tip charged on one slip is ultimately divided and distributed among several employees. This is the heart of the problem. Only that portion of the tip that the recipient retains for his own use is income, wages, or remuneration for employment to him. That portion he shares with other employees is income to them. All these employees would be forced to obtain receipts from each other to substantiate their shares of tip income, since tips are solely the property of employees, and the employer is no more than a conduit between customer and employee for this transaction. Furthermore, existing law already provides the means for prosecuting an employee who falsely reports tip income.

Employers would be unable to accurately report an individual's income, since tip-pooling distributions are not reflected on charge slips, and since the employer would be reporting much of the same income twice—from the charge slip totals and again from the employee's own tip reports. In addition, the new records to be made and retained and the new reports to be filed will cost employers significant time and money, since even small employer have indicated to us that they would need more staff to comply with these new requirements.

Congress has considered the issue of tip-income reporting before, most recently during discussions of the Revenue Act of 1978. The Senate Finance Committee's report on that legislation sums up the problems with the type of reporting proposal now before your Committee:

"The committee has concluded that requiring employers to report to the IRS charge account tips paid to employees on the basis of charge receipts . . . would place unnecessary recordkeeping and reporting burdens on the employer and would fail to provide the IRS with precise information on the amount of tip income taxable to particular employees. In addition, in some cases, the widespread practices of tip-splitting and tip-pooling would result in an employer reporting to the IRS an amount of tip income that is greater than the tip income taxable to a particular employee."

The same arguments stated by the Finance Committee in 1978 are still valid four years later. In addition, we believe the charged-tip reporting proposal imposes unreasonable recordkeeping and reporting burdens on employers and employees and only duplicates data which IRS already has access to, but has not utilized. These burdens of necessity mean higher costs to employers and, ultimately, to consumers. For these reasons, we ask that any type of charge-tip reporting proposal be deleted from the final Committee bill.

NATIONAL TAXPAYERS UNION

A NONPARTISAN, NONPROFIT ORGANIZATION DEDICATED TO THE PUBLIC INTEREST

325 PENNSYLVANIA AVENUE, SOUTHEAST WASHINGTON, DISTRICT OF COLUMBIA 20003 TELEPHONE AREA CODE (202) 543-1300

James D. Davidson
Chairman

George E. Snyder
President

May 20, 1982

Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Rostenkowski:

I am writing to comment on H.R. 6300, "The Tax Compliance Act of 1982," on behalf of the 450,000 family members of the National Taxpayers Union.

The bill, if passed, would continue the recent trend toward more burdensome reporting requirements as well as ever more severe penalties. Why is this necessary? Clearly it's because the average citizen feels that taxes are far too high, are imposed unfairly, and that the Internal Revenue Service (IRS) has been far too heavy-handed in enforcing the nation's tax laws.

While the tax laws become ever more complicated and the penalties harsher for the average taxpayer, congressmen can now claim over $19,000 in tax deductions each year without fear of an audit or penalties. That's unfair.

In the short term, there's little doubt that more taxes could be collected if more resources are given to the IRS and legislation to "increase compliance" is passed. But it's unfair and unwise for Congress to increase penalties for taxpayers without also moving ahead at the same time with new protections for taxpayers to guard against IRS abuses. At the very minimum these protections should include:

* A requirement of a court order to seize property for unpaid taxes, but only after the IRS has made good faith efforts to enter into an installment agreement.

* Updating the exemptions of wages exempt from levy. Inflation has gutted the value of these exemptions.

* Clearing up procedures involving taxpayer interviews. Interviews and audits should be held at a place mutually convenient to the taxpayer and the IRS. The taxpayer should have the option of having the meeting at the office of his attorney, certified public accountant, or tax form preparer. Taxpayers should be allowed to record the interview.

* Ensuring that taxpayers know their rights. Congress should require the IRS to send a comprehensive booklet, written in laymen's terms, to taxpayers when the IRS sends a notice of delinquency or an audit notice.

- * Requiring that written advice by the IRS be binding.

- * Requiring that installment agreements be binding on the IRS.

- * A requirement that the IRS release liens in a timely manner when overdue taxes are paid.

Such procedural safeguards on the IRS will help increase compliance, protect taxpayers and make enforcement fairer.

We strongly oppose the provisions in H.R. 6300 to increase the penalty for premature withdrawals from an Individual Retirement Arrangement (IRA) to 15% from 10%. Such a change would be extremely unfair to those who have made their financial plans based on the previous rules. At the very least, the 10% penalty should be retained for investments made before the effective date of the bill. If such a provision is not made, IRA's will become far less attractive. This is because taxpayers would have little confidence that Congress will not again suddenly change the rules and impose other penalties, new taxes, and new restrictions on previous investments.

In addition, increasing the penalty on premature withdrawals makes IRA's far less attractive to low and middle income taxpayers. This is because the higher the premature withdrawal penalty, the larger the financial cushion needed to provide for emergencies so as to avoid the expensive penalties. Congress should not raise further financial barriers to opening IRA's. Increasing these penalties by 50% will effectively shut out many people of moderate means from opening IRA's. At a time when future Social Security payments are on shaky financial footing, this jeopardizes the retirement plans of millions of average citizens.

A larger penalty would also hurt those who can least afford it. Those who are forced to make a premature IRA withdrawal often face a severe financial emergency. This would be nothing more than a new tax on family financial emergencies.

We are also concerned that the provisions for voluntary withholding of pension income may accidentally result in the collection of taxes from those who owe no tax. We urge the Committee to either remove this provision or provide substantial safeguards for those with no tax liability.

The best way to ensure tax compliance is to move toward tax fairness and tax simplicity. We hope that your Committee will soon examine H.R. 6070, by Congressman Leon Panetta, H.R. 5513, by Congressman Philip Crane, and H.R. 5868 by Congressman Kent Hance and six other members of the Committee. These bills are on the subject of simplifying taxes by eliminating tax credits and deductions and substituting a single rate income tax.

Please make this letter a part of the formal hearing record.

Sincerely,

David Keating
Director of Legislative Policy

New York State Bar Association,
New York, N.Y., April 23, 1982.

Hon. Robert J. Dole,
Chairman, Committee on Finance,
Dirksen Senate Office Building,
Washington, D.C.

Hon. Daniel Rostenkowski,
Longworth House Office Building,
Washington, D.C.

Dear Chairman Dole and Chairman Rostenkowski: The Tax Section of the New York State Bar Association strongly supports the passage of legislation that would provide for a unified proceeding at the partnership level for conducting income tax audits of partnerships and their partners.

The present system of auditing partnerships is extremely defective. It is expensive and cumbersome for the Internal Revenue Service to administer, and it may contribute to tax avoidance. Curing the system's defects should be a high priority for Congress.

A partnership's income and deductions are reported on an information return and each partner is required to report his or her share of partnership items on the partner's individual income tax return. Tax is paid by the partners, not the partnership, and, accordingly, tax deficiencies are assessed at the partner level.

Typically, the Internal Revenue Service examines the partnership's information return, and the revenue agent deals in the first instance with partnership representatives. If the agent concludes that the partnership return is inaccurate, the Service must proceed against each partner to collect the resulting tax deficiency. Each partner may resist a proposed deficiency, even if the representatives of the partnership have agreed to the adjustment. There may be as many administrative and judicial proceedings as there are partners in order to collect taxes arising out of a single transaction. The inadequacies of the present system have come into sharp focus in recent years.

The Tax Section believes that the most effective way to audit partnerships is to require that audits be conducted at the partnership level and that resolutions of issues arising from the partnership income tax return and agreed to by partnership representatives should be binding on the partners except in carefully circumscribed cases. If the basic principle of a unified proceeding is accepted, other ancillary issues must be dealt with, including the rights of dissenting partners to conduct separate administrative and judicial proceedings, the rights of partners to participate in proceedings conducted by the partnership, statute of limitations questions, and procedures for claiming refunds. The Internal Revenue Service is now preparing a legislative proposal to deal with these questions.

The Tax Section does not plan to submit a separate proposal addressing these questions de novo. We are submitting detailed comments to the Internal Revenue Service on its draft proposal and will submit further comments to the appropriate Congressional committees when legislation is introduced. In the meantime, however, we wanted you to be aware of our firmly-held view that a unified proceeding approach is higly desirable and of our general support for the direction in which the Commissioner of Internal Revenue is proceeding in attempting to resolve this important problem.

Sincerely,

Ruth G. Schapiro, *Chairman.*

Profit Sharing Council of America,
Chicago, Ill., May 17, 1982.

Re Sec. 301 of H.R. 6300, The Tax Compliance Act of 1982.

Hon. Dan Rostenkowski,
Chairman, Committee on Ways and Means,
Washington, D.C.

Dear Mr. Chairman: The Profit Sharing Council of America is a non-profit association of employers that maintain tax-qualified deferred profit sharing plans. Approximately 1,400 large and small employers located throughout the United States are members of the Council. The plans maintained by such employers cover approximately 1,750,000 employees.

The Council wishes to offer the following statement with respect to Sec. 301 of H.R. 6300 which would require Federal income tax withholding on distributions from tax qualified profit sharing plans. The Council believes that income tax withholding on profit sharing distributions will impose more administrative complexities, create additional burdens on plan administrators, add to administrative costs and discourage the growth of profit sharing and other retirement plans. In many plans, these additional costs will be charged to the trust and thus will result in an ultimate charge against the accounts of indvidual employee participants and lesser retirement benefits for them.

The Council does not believe there is a substantial loss of revenue through nonreporting of profit sharing distributions. At the present time total distributions are subject to information reporting on form 1099-R and periodic distributions to reporting on form W-2P. Further, many trustees report such distributions on magnetic tape to the IRS. Accordingly, with such types of reporting, the Council can see no justifiable reason for imposing any new administrative burdens on plans.

The proposed Sec. 3405(b)(2)(B) states that the amount of tax to be withheld on total distributions will be based on the 10-year forward income averaging method described under Sec. 402(e) of the Internal Revenue Code. Many participants currently retiring have a substantial portion of their lump sum profit sharing distributions eligible for tax as a long-term capital gain as a result of their participation in the plan prior to 1974. Under the Economic Recovery Tax Act of 1981, capital gains rates have become more favorable and more retirees will utilize the capital gains treatment on their distributions. Withholding under the 10-year forward income averaging method may result in significant over-withholding for those retirees who may elect to use the long-term capital gains provision. It should be noted that the explanation of H.R. 6300 as shown in the Congressional Record indicates that tax would be withheld under special rules designed to reflect the 10-year forward income averaging and capital gains treatment provided for lump sum distributions. However, the proposed Sec. 3405(b)(2)(B) would ignore any special tax treatment available for the portion of the lump sum distribution eligible for long-term capital gains treatment.

One of the ostensible reasons for requiring withholding is to apparently decrease the noncompliance of tax reporting on qualified plan distributions. The Council does not believe there is any substantial loss of revenue for non-reporting of this type of retirement income. Nevertheless, it is suggested that if any possible withholding requirements are adopted that they not be applied to those payors who report to the IRS by magnetic tape. With magnetic tape reporting, the IRS would be assured of being able to actively pursue noncompliance.

The Council is concerned that the withholding requirements will add substantial additional administrative burdens to profit sharing plan administrators and trustees. There seems to be widespread agreement that there should be a reduction in paper work and the elimination of unnecessary reporting and regulatory compliance measures, The imposition of new withholding requirements is contrary to these admirable goals.

Respectfully submitted,

WALTER HOLAN, *President.*

TAX EXECUTIVES INSTITUTE, INC.,
Arlington, Va., April 8, 1982.

Re H.R. 5829 "The Taxpayer Compliance Improvement Act of 1982".

HON. DAN ROSTENKOWSKI,
Chairman, House Committee on Ways and Means,
Washington, D.C.

DEAR MR. CHAIRMAN: Tax Executives Institute, Inc. ("TEI") is an organization with approximately 3,800 individual members representing over 1,100 of the leading corporations in North America. Membership in TEI consists of persons employed by corporations who are charged with the administration of the tax affairs of their employers in an executive, administrative or managerial capacity.

As an organization dedicated to the principle of fair and equitable adminstration of and compliance with the nation's tax laws, TEI is deeply concerned about the large amount of unreported income that is reputed to exist in the "underground economy". Consequently, we strongly support the basic objectives of H.R. 5829. However, we also feel strongly that some sections of the bill are either unadministrable or would cause unwarranted financial costs to be incurred by law-abiding corporate taxpayers. Some proposals in the bill would clearly result in a significant overkill and would serve to portray the multitude of honest corporate taxpayers who are fully complying with the law in the same adverse light as the "underground economy". We do not believe that such results were intended by the sponsors of the bill and respectfully request that such sections be reconsidered.

We are herein submitting our written comments on three proposals in the bill which we feel lack merit and which should not be adopted. We hope that our comments will be helpful to you and your Committee and that they adequately demonstrate the need for changes in the bill.

When your Committee schedules hearings on H.R. 5829, we respectfully request an opportunity to present oral testimony in addition to the above written comments. We would be most pleased to provide any assistance in these matters that you would feel to be helpful.

Respectfully submitted,

THOMAS P. MALETTA, *President*.

STATEMENT OF TAX EXECUTIVES INSTITUTE, INC., ON H.R. 5829—THE TAXPAYER COMPLIANCE IMPROVEMENT ACT OF 1982

SECTION 113—RESTRICTIONS ON PAYMENT OF INTEREST FOR CERTAIN PERIODS

Paragraph (c) of this section of the bill would eliminate the present requirement that the Internal Revenue Service pay interest to a taxpayer on a tax refund due to a net operating loss, capital loss or investment credit carryback for the period beginning with the date of the close of the taxable year in which the carryback item arose and ending with the date the money is actually paid to the taxpayer. The bill would preclude a taxpayer from earning such interest until the entire completed tax return and claim for refund are filed with respect to the taxable year of the loss or in which the excess credit arose.

TEI believes that this is a totally inequitable proposal. The larger corporations, most of which are multi-divisional, multi-company and multi-national, simply cannot collect and properly analyze the tremendous volume of data which is required to file a complete and proper tax return much before the eight and one-half month period (including extensions) presently allotted for timely compliance. The thousands of transactions involved and the complicated laws and regulations governing them just will not normally permit an earlier filing. All the economic events which create the tax refund have occurred by the end of the taxable year and to deny a taxpayer interest on the tax refund legally due him during this period would be a major injustice.

Under all other similar conditions when either a taxpayer or the Internal Revenue Service owes the other money interest is paid to the creditor involved. This includes interest paid to the Internal Revenue Service on audit adjustments arising out of court decisions rendered or new Regulations published several years after a tax return has been filed. it would be totally inequitable to make a unilateral exception in favor of the government when a taxpayer merely requires time to properly comply with the many tax laws affecting it.

If the objective of this sub-section of the bill is to eliminate the small advantage that the present 20 percent interest rate paid by the Internal Revenue Service has over the present market rate and to encourage taxpayers to file their returns and refund claims as soon as possible, then we believe that such an objective will be achieved by Sections 111 and 112 of the bill. These sections provide that the Internal Revenue Service interest rate will be determined semi-annually and computed on a compound basis, rendering paragraph (c) of the Section 113 totally unnecessary. Once an appropriate interest rate is established, any problems which currently exist will disappear.

Thus, in our view, paragraph (c) is unwarranted and should be deleted from Section 113 of the bill.

SECTION 121—FRAUD PENALTY ON CORPORATE DIRECTORS, OFFICERS, EMPLOYEES AND AGENTS

This section would impose a personal financial penalty on the individual directors, officers, employees or agents of a corporation who knowingly participate in tax fraud on behalf of a corporation resulting in a tax deficiency by the corporation. Such penalty would be an amount equal to 50 percent of the part of the underpayment of corporate tax attributable to the conduct of the individual, with a maximum of $100,000 per individual for each return. TEI is very proud of the compliance record of the corporate tax administration profession and our Standards of Conduct would not permit any member convicted of tax fraud to remain in the Institute. However, we feel that the existing criminal tax fraud penalty, the threat of stockholder derivative suits and other sanctions (e.g., employee termination) already provide sufficient deterrents to public corporation tax fraud.

The number of cases where public corporations have been accused of engaging in tax fraud has been minimal and the number of cases where such corporations have been convicted of wrongdoing has been extremely rare. We understand that only 5 percent of the "noncompliance gap" is due to the corporate sector, and suggest that only a minor part of this 5 percent is attributable to public corporations. We are at a loss to see how this additional penalty would serve any substantial useful purpose or raise any additional revenue for the government. On the other hand, it certainly could be used as a type of Sword of Damocles by IRS auditors dealing with individual corporate officers or employees.

Proposed Code Section 6653(f)(3)(A) states that "knowing participation in fraud" includes participation with respect to which such individual "knew, or should have known, that such participation would result in an underpayment of tax". This is a sweepingly broad and imprecise standard and could surely result in penalties being proposed as to people who, at the time, acted in good faith but who, many years later and with the benefit of hindsight, are found to have made poor judgments. The proposed penalty could decrease the fairness of our extremely complex tax system by inhibiting responsible corporate tax officers and employees from taking positions on complicated tax issues which they feel are correct but which may be attacked later by the Internal Revenue Service. Since an officer or employee of a publicly held corporation (who is not a large shareholder therein) would receive no personal financial benefit from the corporation underpaying its taxes, it would seem unfair to financially penalize the individual for his actions as an employee.

Because of the lack of a demonstrated problem which requires solution, the existence of sufficient penalty provisions, the broad and imprecise standard being suggested, and the possibility of intimidation of private sector personnel by government auditors, we believe Section 121 is unwarranted and should be deleted from the bill.

SECTION 125—PENALTY FOR SUBSTANTIAL UNDERSTATEMENT OF TAX

As it relates to corporations, this section of the bill would impose an additional penalty in an amount equal to 10 percent of the amount of any underpayment of tax arising, in effect, from any item of adjustment not specifically "disclosed" in the tax return where the total underpayment exceeds the greater of $10,000 or ten percent of the corrected tax liability. The penalty would be imposed without regard to fault or the nature of the adjustment items if the items to which the tax deficiency is attributable are not specifically disclosed on the return.

Underpayments of tax by larger corporations are generally due largely to highly judgmental adjustments by the Internal Revenue Service, the general categories of which are set out on the return; however, because of the large volume of the individual transactions, such items are not specifically identified in detail. Such controversial items commonly include amounts capitalized by the Internal Revenue Service which are treated on the return as expenses, useful lives for depreciation purposes, the proper amount of reserve for bad debts, valuation of inventories, and the proper amount to accrue for various liabilities. Such adjustments can temporarily produce significant tax deficiencies. However, because of the uncertainty that has traditionally existed concerning the proper treatment of such items, there should be no penalty imposed if the taxpayer has a reasonable basis for its position. In these times of diminished business income, the safe harbor threshold amounts and percentages offer little solace to the corporate taxpayer.

In regard to the suggestion that perhaps "unusual" items be specially flagged on the return, it is pointed out that the Internal Revenue Service already requires that corporate taxpayers, reconcile, in detail, all differences between the company's financial statements and its tax return on what is known as "Schedule M."

Considering the substantial nature of the existing negligence and fraud penalties and the fact that the bill will otherwise ensure that current interest rates are paid on deficiencies, TEI believes that sufficient deterrents to the so-called "audit lottery" already exist, insofar as publicly held corporations are concerned. Furthermore, approximately 1000 of the large corporations in the United States have historically been examined every year by the Internal Revenue Service under the Coordinated Examination Program (more commonly referred to as the "large case audit program"). Accordingly, there is no audit lottery for large corporations. Therefore, we request that Section 125 be deleted from the bill.

TAX EXECUTIVES INSTITUTE, INC.,
Arlington, Va., May 18, 1982.

Re H.R. 6300 "Tax Compliance Act of 1982."

Hon. DAN ROSTENKOWSKI,
Chairman, House Committee on Ways and Means,
Washington, D.C. 20515

DEAR MR. CHAIRMAN: Tax Executives Institute, Inc. ("TEI") is an organization with approximately 3,800 individual members representing over 1,100 of the leading corporations in North America. Membership in TEI consists of persons employed by corporations who are charged with the administration of the tax affairs of their employers in an executive, administrative or managerial capacity.

As an organization dedicated to the principle of fair and equitable administration of and compliance with the nation's tax laws, TEI is deeply concerned about the large amount of unreported income that is reported to exist in the "underground economy" and other activities involving tax fraud. Consequently, we strongly support the basic objectives of H.R. 6300. However, we also feel strongly that some sections of the bill are very inequitable and would cause unwarranted financial costs to be incurred by law-abiding corporate taxpayers. Some proposals in the bill would result in an overkill and would serve to portray the multitude of honest corporate taxpayers who are fully complying with the law in the same adverse light as the "underground economy". We do not believe that these results were intended by the sponsors of the bill and respectfully request that such sections be reconsidered.

We are herein submitting our written comments on three proposals in the bill which we feel lack merit and which should either not be adopted or be appropriately amended. We hope that our comments will be helpful to you and your Committee and respectfully request that they be entered as part of the record of the hearing held May 18, 1982.

We would be most pleased to provide any further assistance in these matters that you would feel to be helpful.

Respectfully submitted.

THOMAS P. MALETTA, *President.*

STATEMENT OF TAX EXECUTIVES INSTITUTE, INC., ON H.R. 6300—TAX COMPLIANCE ACT OF 1982

SECTION 122—PENALTIES FOR DOCUMENTS UNDERSTATING TAX LIABILITY

As it relates to corporations, this section of the bill would provide a new $5,000 personal penalty on any individual who aids or assists in, procures, or advises in the preparation or presentation of a return, affidavit, claims or other document in connection with any matter arising under the internal revenue laws who knows that the use of such document will result in an understatement of corporate tax liability.

TEI is very proud of the compliance record of corporate tax administrators and we believe that the existing criminal fraud penalty, the threat of stockholder derivative suits and other sanctions (e.g., employee termination) already provide sufficient deterrents to public corporation tax fraud. A public corporation is, of course, also subject to scrutiny by a multitude of other government agencies, e.g., Security and Exchange Commission, etc. as well as the Internal Revenue Service.

The number of cases where public corporations have been accused of engaging in tax fraud has been minimal and the number of cases where such corporations have been convicted of wrongdoing has been extremely rare. We understand that only 5 percent of the "noncompliance gap" is due to the corporate sector, and suggest that only a minor part of this 5 percent is attributable to public corporations. We are at a loss to see how this additional penalty, as it relates to public corporations, would serve any substantial useful purpose or raise any additional revenue for the government. On the other hand, it certainly could be used as a type of Sword of Damocles by IRS auditors dealing with individual corporate officers or employees. The threat of personal jeopardy to corporate employees could make them more passive in their dealings with the IRS and, consequently, could cause erosion of the adversary process in our tax system. It could also lead to conflicts of interest between employees and their corporations by encouraging employees to avoid taking controversial positions in areas where the law is unsettled. Since an officer or other employee of a publicly held corporation (who is not a large shareholder therein) would receive no direct personal financial benefit from the corporation underpaying its taxes, it would seem unfair to financially penalize the individual for his actions as an employee.

Because of the lack of a demonstrated problem which requires solution, the sufficiency of presently existing penalty provisions and the possibility of intimidation of private sector personnel by government auditors, we believe that either Section 122 should be deleted from the bill or it should be amended to provide an exception for employees of corporations with a class of securities registered pursuant to Section 12, or required to file reports pursuant to Section 15(d) of the Securities Exchange Act.

SECTION 502—RESTRICTION ON PAYMENTS OF INTEREST FOR CERTAIN PERIODS

Paragraph (c) of this section of the bill would eliminate the present requirement that the Internal Revenue Service pay interest to a taxpayer on a tax refund due to a net operating loss, capital loss or investment credit carryback for the period beginning with the date of the close of the taxable year in which that carryback item arose and ending with the date the money is actually paid to the taxpayer. The bill would preclude a taxpayer from earning such interest prior to the due date, with extensions of the return of the taxable year of the loss or in which the excess credit arose. This would cause a taxpayer to be denied interest for the period during which he is closing the books and preparing the tax return and related claim for refund.

TEI believes that this is a totally inequitable proposal. The larger corporations, most of which are multi-divisional, multi-company and multi-national, simply cannot collect and properly analyze the tremendous amount of data which is required to file a complete and proper tax return before the eight and one-half month period (including extensions) presently allotted for timely compliance. The thousands of transactions involved and complicated laws and regulations governing them just will not normally permit an earlier filing. All the economic events which create the tax refund have occurred by the end of the taxable year and to deny a taxpayer interest on the tax refund legally due him during this period would be a major injustice.

Under similar conditions, when either a taxpayer or the Internal Revenue Service owes the other money, interest is paid to the creditor involved. This includes interest paid to the Internal Revenue Service on audit adjustments arising out of court decisions rendered or new Regulations published several years after a tax return has been filed. It would be totally inequitable to make a unilateral exception in favor of the government when a taxpayer merely requires time to properly comply with the many complex tax laws affecting it.

If the objective of this sub-section of the bill is to eliminate the small advantage that the present 20 percent interest rate paid by the Internal Revenue Service has over the present market rate and to encourage taxpayers to file their returns and refund claims as soon as possible, then we believe that such an objective could best be achieved by a provision requiring that the Internal Revenue Service interest rate be determined quarterly, or at least semi-annually, and computed on a compound basis. Such a provision would render paragraph (c) of Section 502 unnecessary. Once an appropriate interest rate is established, any problems related to interest in carrybacks which currently exist will disappear.

Thus, in our view, paragraph (c) is unwarranted and should be deleted from Section 502 of the bill.

SECTION 503—INTEREST SURCHARGE ON SUBSTANTIAL UNDERSTATEMENT

This section of the bill would impose an additional penalty in an amount equal to 20 percent of the interest payable with respect to any underpayment attributable to an understatement of tax for any year if the amount of understatements is at least 10 percent of the actual tax liability and $5,000 or at least 50 percent of the actual tax liability and $500. The penalty would be imposed without regard to fault or the nature of the adjustment items.

Underpayments of tax by publicly held corporations are generally due largely to highly judgmental adjustments by the Internal Revenue Service. Such controversial items commonly include amounts capitalized by the Internal Revenue Service which are treated on the return as expenses, useful lives for depreciation purposes, the proper amount of reserve for bad debts, valuation of inventories, and the proper amount to accrue for various liabilities. These type adjustments can indeed produce signifiant tax deficiencies in a given year but such results prove to be only temporary as the corporation is entitled to the deductions in subsequent years. In these times of diminished business income, the safe harbor threshold amounts and percentages offer little solace to the corporate taxpayer.

Considering the substantial nature of the existing negligence and fraud penalties and the fact that hopefully the bill will otherwise ensure that current interest rates are paid on deficiencies, TEI believes that sufficient deterrents to the so-called "audit lottery" already exist, insofar as publicly held corporations are concerned. Furthermore, approximately 1,000 of the large corporations in the United States have historically been examined every year by the Internal Revenue Service under the Coordinated Examiniation Program (more commonly refered to as the "large case audit program"). Accordingly, there is no audit lottery for large corporations.

Therefore, we request that either Section 503 be deleted from the bill or be amended to provide an exemption for corporations with a class of securities registered pursuant to Section 12, or required to file reports pursuant to Section 15(d), of the Securities Exchange Act. At the very least, the bill should be changed to provide that the Secretary must waive application of the penalty on a showing by the taxpayer that there was a reasonable basis for the understatement and that the taxpayer acted in good faith. The flexibility allowed the Secretary by the bill as presently drafted would create unnecessary controversy and litigation.

UNITED LABORATORIES OF AMERICA, INC.,
Dallas, Tex., May 13, 1982.

HON. DANIEL ROSTENKOWSKI,
U.S. House of Representatives,
Washington, D.C.

DEAR REPRESENTATIVE ROSTENKOWSKI: I want to go on record as strongly opposing your bill H.R. 6300. My reasoning for this stand is that your bill does not impose any safe harbor for direct sellers. It does impose unfair information reporting burdens. As the owner of a company which deals solely with independent contractors to distribute our product, I find that the overwhelming majority of these people are good citizens who pay their proper taxes, and I feel that they, as well as I, resent any implication to the contrary.

On the other hand, I want to go on record as supporting H.R. 6311 introduced by Congressman Gephardt and Congressman Conable. the Gephardt-Conable bill approaches direct sellers with an acceptable overall concept, i.e., it contains a safe harbor test direct sellers can meet as well as information reporting requirements that do not question the integrity of those engaging in this form of business.

Representative Rostenkowski, direct sellers represent the "American way of life" in that they have the opportunity to receive remuneration in proportion to the energy they expend. The more red tape and bureaucracy imposed on these budding entrepreneurs, the less they will be willing or able to control their destiny. It is my desire to see the freedom of the people retained by Americans.

I urge you to consider carefully my statements above. As an elected representative of the people, you are surely aware of the growing discontent of your constituency with more government control.

Yours truly,

BILL J. SPARKS, *President.*

USAA INVESTMENT MANAGEMENT CO.,
San Antonio, Tex., May 24, 1982.

HON. DANIEL ROSTENKOWSKI,
Chairman, House Committee on Ways and Means,
Washington, D.C.

DEAR MR. ROSTENKOWSKI: The six compliance challenges to the income tax law that are addressed in H.R. 6300, the Tax Compliance Act of 1982, if passed into law, reduce the means available to the scofflaws to evade or significantly reduce the amount of taxes they pay.

On initial review there are two titles of the proposed legislation which appear troublesome and could adversely affect the large majority of taxpayers who comply with the law more than it does those who do not. These titles are: Title II Improved Information Reporting and Title III Pensions and Other Retirment Income.

The impact of Title II, if the bill is enacted into law, cannot be fully assessed until the rules and regulations implementing it are issued by the Treasury. However, compliance with this section of the proposed bill will surely increase the operating costs of small businesses, brokers, bankers and corporations which in turn will be passed on to the consumer as part of the cost of doing business. Again, the law-abiding taxpayer will comply and pay the increase cost while those who flaunt the law will, as in the past, continue to do so.

The primary area of our concern, however, is Section 311 of Title III which increased the excise tax on early distributions from an IRA from 10 percent to 15 percent. Our experience with IRA account holders is that early distribution is almost always the result of a crisis (illness, loss of job, etc.) rather than "I can afford the penalty because I will earn more in an alternative investment." The enhanced IRA program, legislation much to be applauded, is increasing savings and those who are saving via the IRA, in the majority, are not the sophisticated investors who are prone to rapid changes in investment objectives.

The additional 5 percent penalty on an early distribution, would be sufficient, in our opinion, to keep many small or potential IRA savers from adding to or starting an IRA. Many look on the IRA as their last resort emergency fund. They also feel that the 10 percent penalty is a reluctantly acceptable necessity. We believe, however, an increase of 5 percent in the penalty would significantly decrease the savings which are now flowing to IRA accounts.

We recommend strongly that Section 311 of Title III be deleted from H.R. 6300, the Tax Compliance Act ot 1982.

Sincerely,

GEORGE K. SYKES,
Executive Vice President.

STATEMENT OF THE U.S. LEAGUE OF SAVINGS ASSOCIATIONS

The U.S. League of Savings Associations [1] supports the efforts of Chairman Rostenkowski (H.R. 6300) and ranking minority member Mr. Conable (H.R. 5829) to improve compliance with our income tax laws. Greater compliance will increase revenues and eventually ease the tax burden on all taxpayers. In addition, closing the tax compliance gap will also strengthen our voluntary tax system.

However, as strongly as we support the overall objective of these two bills, the savings and loan business would like to make recommendations for improving the numerous provisions contained in this legislation. It is with this spirit of cooperation that we make the following suggestions.

INFORMATION REPORTING AND WITHHOLDING

The savings and loan business is in total agreement with the Treasury that illegal or inadvertent tax-evasion is indefensible. In support of this position, our business has become a leader in the development of an effective interest-reporting program in order to improve compliance. This program, mandated by Congress in 1962, involves the matching of income information documents (1099 forms) against income tax returns. Its purpose is to give the IRS the ability to determine whether a taxpayer has fully reported on his tax return his taxable income included on information documents and to identify individuals who have never filed a tax return.

Internal Revenue Service estimates, based upon 1976 income, show that 84 percent of interest income (from all sources) was reported to the IRS that year. Because of improved magnetic tape reporting among financial institutions, today's estimate of reportable interest income is now well over 90 percent—and certainly must be an even greater percentage for customers of depositories supplying Form 1099. By continuing to improve our system of 1099 reporting, the savings and loan business has faithfully supplied both the IRS and the depositor with the necessary annual information to improve taxpayer compliance. Therefore, as a leading participant, the saving and loan business welcome all efforts to improve and broaden the information reporting program. From our point of view and that of the business community as a whole, information reporting in terms of cost, administrative difficulty and customer relations is far more preferable than the alternative—withholding.

---

[1] The U.S. League of Savings Associations has a membership of 4,100 savings and loan associations representing over 99 percent of the assets of the $650 billion savings and loan business. League membership includes all types of association—Federal and state-chartered, stock and mutual. The principal officers are: Roy Green, Chairman, Jacksonville, FL; Leonard Shane, Vice Chairman, Huntington Beach, CA; Stuart Davis, Legislative Chairman, Beverly Hills, CA; William B. O'Connell, President, Chicago, IL: Arthur Edgeworth, Director, Washington Operations; Glen Troop, Legislative Director; and Phil Gasteyer, Associate Director, Washington Operations. League headquarters are at 111 East Wacker Drive, Chicago, IL. 60601. The Washington Office is located at 1709 New York Avenue, N.W. Washington, D.C. 20006. Telephone: (202) 637-8900.

The current Administration first requested, but now, we understand, has abandoned the concept of withholding in this year's effort to raise needed tax revenue. Congress, on numerous occasions, has also strongly opposed withholding on interest and dividend payments. Yet, in spite of the often repeated difficulties, including operational and cost problems foisted upon the payor institutions, withholding continues to be suggested to improve compliance. Under both H.R. 6300 and H.R. 5829, withholding is employed as a collection tool for the taxpayer who fails to supply the proper taxpayer identification number (TIN). Since the taxpayer is liable for the tax on interest he receives, withholding imposes only a small inconvenience. The real party being penalized by requiring withholding is the third-party payor institution which must establish the complicated and costly withholding mechanism for a few uncooperative taxpayers. The more equitable enforcement device is to impact directly the violator by increasing his dollar penalty for failing to supply identifying numbers. Both H.R. 6300 and H.R. 5829 require increased penalties and we feel that this change, not withholding, is the proper enforcement approach.

In regard to provisions in both bills that impose withholding on distributions from pensions, annuities or IRA-Keogh plans, the U.S. League, on behalf of the savings and loan business, firmly opposes mandating this tax collection procedure. One of the most persuasive arguments raised against withholding during this entire controversy was the hardship against withholding during this entire controversy was the hardship being borne by our elderly savers and retirees who have no income tax liability and depend on their interest and dividend income to live on. Under H.R. 6300 and H.R. 5829, recipients could elect not to have withholding apply to their pension distributions; however, since a specific action will be required, many elder citizens may be subjected to withholding unintentionally or unknowingly. Also, since non-periodic distributions from pensions would require a separate election each and every time, the chances for withholding to occur even though unwanted by the taxpayer would be increased. To avoid these unncessary difficulties on both the taxpayer and institution, a notice could be provided by the payor institution to all those receiving pension distributions that taxes could very well be owed on these pension distribution amounts.

In addition, withholding, if enacted for pension distributions or taxpayer failure to supply identifying numbers, is a new and complicated procedure which will require much more start-up time than provided in either H.R. 6300 or H.R. 5829, both of which would take effect January 1, 1983.

Finally, the Internal Revenue Service was established as the agency with primary responsibility for collecting government revenues. The financial community, while cooperating in every respect through information reporting, etc., does not wish to become their depositors' tax collector. The IRS is much better equipped and postured to handle this difficult and sensitive task.

RESTRICTIONS ON PAYMENT OF INTEREST ON CERTAIN REFUNDS

Under H.R. 6300, interest on a tax refund arising from a net operating loss (capital loss, etc.) carryback would begin accruing on the due date (with extensions) of retun for the year in which the carryback arose. H.R. 5829 would deny interest for any period prior to the date the refund is claimed or otherwise applied for. In either instance, existing law, which allows interest to be paid on a net operating loss tax refund from the day after the end of the loss year, would be altered.

This change will be particularly onerous to savings and loan institutions which are suffering escalating losses as a result of prolonged high interest rates. If the overpayment of tax exists from the first day of the year following the loss year, then interest should accrue from that time. If concern exists because the applicable interest rate is unusually high (currently 20 percent), then provision should be made to adjust the rate more frequently and not deny the full interest refund benefit to deserving taxpayers. Certainly, in this instance, the government is attempting to deny a legitimate interest accrual to unfortunate taxpayers who have incurred a net operating loss and subsequent tax overpayment, while it continues to receive substantial interest income from tax deficiencies at the current 20 percent rate. This is an example of the existing inequity regarding the interest payment rules on tax refunds and deficiencies which already favor government over the individual or corporation.

Another problem resulting from H.R. 5829 is acceleration of the filing of the association's tax return and refund claim. It is a tremendous undertaking for many associations, especially smaller, neighborhood associations, those involved in mergers and those with ten-year loss carrybacks to file their tax returns by the normal tax due date, much less January 1, 1983, as required by H.R. 5829. Such accelerated requests for payments of refunds by taxpayers places a heavy burden on associations and their accountants, while also exacerbating the present government budget situation on a cash basis. If the prompt filing of tax claims is the desired objective, then provide the taxpayer with a reasonable period to file both his return (with extensions) and refund claim. Those filing within the prescribed time period will receive interest on their refunds from the beginning of the tax year.

MAGNETIC TAPE REPORTING

The U.S. League supports the provision contained in H.R. 6300 which requires the Secretary, when prescribing regulations for magnetic tape reporting of interest, to take into account the cost of the filing requirement to the taxpayer or payor institution. Some of our institutions are still filing paper returns, not by choice but because of cost. These small institutions would be hard pressed to absorb any increase in processing costs in today's economic conditions. A solution to this problem might be to exempt associations with a small amount of deposits from this magnetic tape reporting requirement. For these reasons, we oppose the provision contained in H.R. 5829 which doesn't provide for consideration of cost before implementing magnetic tape interest reporting.

PROVISIONS RELATING TO INDIVIDUAL RETIREMENT ACCOUNTS

Finally, two provisions are included in H.R. 6300 which deserve comment. The U.S. League strongly endorses extending partial rollover authority to IRA distributions. This increased flexibility given to the Individual Retirement Account is totally consistent with its primary retirement income purpose and we support the Chairman's effort.

However, the provision which calls for increasing the 10 percent excise tax on early withdrawals from IRA accounts to 15 percent we oppose. Such an increase could discourage potential IRA investment already suffering because of its long-term nature. The savings and loan business is the largest seller of IRA accounts and we have no evidence that withdrawals for investment reasons are increasing. And we certainly don't want to raise the penalty for emergency withdrawals from IRA accounts. Therefore, we oppose raising the 10 percent excise tax to 15 percent until evidence of abuse is provided.

The U.S. League greatly appreciates this opportunity to present its views to the Committee on Ways and Means.

Groom & Nordberg,
Washington, D.C., June 4, 1982.

Re Hearings on Proposed Taxpayer Compliance Legislation (H.R. 5829 and H.R. 6300)—Withholding on Pensions and Other Retirement Income.

Hon. Dan Rostenkowski,
Chairman, Committee on Ways and Means,
Washington, D.C.

Dear Mr. Chairman: This statement is respectfully submitted on behalf of the Western Conference of Teamsters Pension Trust Fund ("WCT Plan") for inclusion in the record of the May 18, 1982 hearings of the Committee on the above-referenced proposed legislation.

The WCT Plan is the largest multiemployer pension plan in the United States. The Plan currently receives contributions of behalf of more than 500,000 employees working under Teamster collective bargaining agreements with nearly 15,000 employers in 13 western states. More than 100,000 retirees and survivors are currently receiving benefits under the WCT Plan. As of December 31, 1981, the Plan's total assets exceeded $3.6 billion and all such assets are on deposit with The Prudential Insurance Company of America pursuant to a group annuity contract. The WCT Plan is administered by 28 trustees jointly represently management and labor pursuant to the Labor-Management Relations Act, 1947.

I. SOME GENERAL COMMENTS ON PENSION WITHHOLDING

Both H.R. 5829 and H.R. 6300 would make substantial changes in the obligations of plan administrators and payors with respect to the withholding of Federal income tax on periodic and other payments made from tax-qualified retirement plans. Specifically, both bills would change present law (under which taxes are withheld from periodic and other pension payments only upon the affirmative request of the recipient) by establishing a system under which withholding would be required except to the extent that the recipient elects not to have withholding made.

The WCT Plan does not support the enactment of pension withholding legislation. However, this statement is submitted on the basis that if, notwithstanding the objections which the pension community has raised, the Committee does make changes in the current rules along the lines of those contained in H.R. 6300 and H.R. 5829, it is essential that any such changes recognize the needs of multiemployer plans for rules that reasonably reflect their current claims procedures and benefit payment practices. Our specific recommendations concerning such rules are provided below.

We very much share the general concerns expressed by the public witnesses at the Committee's hearings (including the National Coordinating Committee for Multiemployer Plans) with respect to the need to carefully consider the potential impact of such legislation on retirees, on the administrative costs and capabilities of plans, their sponsors and payors, and on the importance of providing substantial leadtime for plans, employers and payors to modify or develop the administrative, computer and other systems needed to comply with any new withholding requirements in an orderly and cost-effective manner. In this regard, we would emphasize that increased administrative costs adversely affect all plans and all sponsors, and that the effect of such increased costs on multiemployer plans and their participants is particularly substantial. More specifically, while sponsors of single employer plans might in some cases be able to assume the increased administrative costs associated with any new withholding requirements, the administrative costs of a multiemployer plan can only be paid from the trust fund itself, and such costs directly and immediately reduce the amount of funds which the plan has available to pay benefits to its participants and beneficiaries. The following recommendations are designed to minimize the increased administrative costs and burdens that any new or revised withholding requirements could impose on the WCT Plan (and, presumably, on multiemployer plans generally).

II. SPECIFIC RECOMMENDATIONS

1. Elections not to have withholding apply to periodic pension payments

Virtually all of the witnesses have emphasized that the annual election requirements of H.R. 5829 would impose very substantial burdens and costs on retirees, plan administrators and payors. The WCT Plan agrees that such a procedure would impose immense and unnecessary obligations on all of these parties. The prospect of having to administer, on an annual basis, income tax withholding elections with respect to the 100,000 persons who are currently receiving benefits under the WCT Plan—averaging only $239 per month—is mind-boggling to say the least. Indeed, the apparent need to have to administer this process on only a one-time basis (pursuant to H.R. 6300) will, by itself, tax the administrative capabilities and resources of the Plan to the fullest. In our view, the circumstances that would confront the WCT Plan (and other large plans of all types) in this respect clearly illustrate (1) the need for an effective date extending well beyond (e.g., at least one year) the date of enactment of any legislation in this area, and (2) that serious consideration should be given to limiting any new pension withholding system (whether voluntary or mandatory) to periodic payments in excess of a reasonable "floor" that takes into account the effects which personal exemptions and the zero bracket amount have on the tax liability of the typical retiree who has no significant income other than his or her pension and Social Security benefits.

2. Notification of right to elect not to have withholding apply to periodic pension payments

Unlike H.R. 5829 (which leaves the details to regulations), H.R. 6300 includes specific rules with respect to the time for furnishing the pension recipient with notice of his or her right to "elect out" of withholding. Specifically, under H.R. 6300, notice would have to be furnished no earlier than 2 months before the date of the first payment. H.R. 6300 also provides that withholding would not be required with respect to any "periodic payments made before the close of the 2nd calendar month after the month in which such payments begin" (prop. sec. 3405(a)(3)(A)).

We have two concerns in this area.

First, we believe it is important that any such legislation allow plans (and payors) to establish whether taxes are to be withheld, and the amount to be withheld, with the first benefit check. From the WCT Plan's standpoint, delays in withholding can only increase administrative costs since adjustments to benefit checks involve programming and other revisions to plan records. In the aggregate, these costs can be substantial.

Second, it is essential that any rules relating to the time for furnishing notice provide adequate flexibility to accommodate reasonable and customary plan procedures for processing claims for benefits. Under the WCT Plan, for example, applications for benefits are commonly filed 3 months before the participant's desired pension effective date, but many persons file as early as 6 months in advance and others apply closer to their desired effective dates. Moreover, while claims are ordinarily processed within 3 months, there are many cases where the process of verifying past service credits, birth dates, marital status, etc. takes somewhat longer.

If withholding requirements along the lines of H.R. 6300 were imposed, the WCT Plan contemplates that it would notify applicants of their rights to "elect out" by including appropriate tax material with the other material which the Plan commonly sends to applicants soon after their applications have been received. However, the bill does not appear to provide adequate flexibility in this respect. Accordingly, we recommend that any statutory notice requirements provide that notice may be furnished no earlier than the later of (1) 6 months before the first payment is made, or (2) the date on which an application for benefits is made if the plan requires that a claim for benefits be made before the payment of benefits may commence. This approach would more accurately reflect the practical needs of plans while, at the same time, providing individuals with the relevant tax information reasonable close to the time when their pension payments are to commence.

3. Effect of suspensions of benefits on elections already made

While not clearly reflected in H.R. 6300, the Joint Tax Committee staff's explanation of the bill indicates that if periodic payments are suspended "for example, by reason of a retiree's return to the service of the employer", then the first payment after the suspension would be treated as the commencement of periodic payments.[1] (Presumably, this means that there would have to be another notice of the opportunity to "elect out" and that withholding would be made unless a new "election out" were received.) While such a requirement may be simple enough to state, compliance with any such requirement would impose tremendous and unnecessary burdens on multiemployer plans and their retirees.

Multiemployer plan administration of the suspension of benefits provision of ERISA (IRC sec. 411(a)(3)(B)) has already been immensely complicated by recently-issued regulations of the Department of Labor. Moreover, plans have always experienced practical difficulties with respect to receiving timely notice of a retiree's reemployment so that benefits may be suspended (where allowable) in a relatively timely manner. In our view, the introduction of new withholding responsibilities in this area would only make a difficult situation worse and, in addition, it would do so for no useful purpose.

In a large plan like the WCT Plan, thousands of retirees may be reemployed for some period of time in a single year. Benefits may be suspended and resumed several times in one year with respect to the same person. Moreover, since several months usually elapse before the plan first learns of a retiree's reemployment, it is not at all uncommon for a suspension of benefits to occur (in accordance with applicable regulations) several months after the retiree has actually ceased his or her period of re-employment and is no longer earning current income.

We recognize that the fact of reemployment may indicate a possible change in a person's income tax situation. On the other hand, it is also true that the typical period of suspension is quite short, that payments may well resume in the taxable year after the taxable year in which the retiree was temporarily reemployed and, most importantly, that a retiree may also return to work (and have current income) from employment that is not employment for which a suspension of benefits is permissible in the first instance.

In view of the requirement of H.R. 6300 to provide annual notice to payees of the procedures for withholding on periodic payments, there is no sound reason to treat the mere resumption of benefits to a payee as the commencement of benefits. Indeed, in view of the immense problems that such a requirement would create for multiemployer plans, we recommend that it be made clear (if legislation along the lines of H.R. 6300 is adopted) that a prior "election out" is to remain in effect notwithstanding that benefits may have been suspended and resumed.

4. Certain non-periodic payments under multiemployer plans

With one exception, all benefits under the WCT Plan are paid on a monthly basis. The exception is a single-sum death benefit—the maximum amount is currently $10,000—which is payable to the beneficiary of a participant on account of the participant's death before retirement. While multiemployer plans are free to provide for the payment of retirment or other benefits in a single-sum, many defined benefit multiemployer plans are comparable to the WCT Plan in this respect.

---

[1] Comparative description of H.R. 6300 and H.R. 5829, p. 25 (Jt. Comm. Tax., May 12, 1982).

It would appear that, under H.R. 5829 and H.R. 6300, the modest single-sum death benefit of the type which the WCT Plan provides would be subject to the withholding provisions for non-periodic payments. Also, it seems clear that any withholding rules which are adopted for non-periodic payments will be quite different from (and more complex than) any withholding rules that are adopted for periodic payments. Significantly, the treatment of death benefits of the type provided by the WCT Plan is already addressed in some way under both bills, and the Treasury Department has recommended to the Committee that "the maximum $5,000 death benefit under section 101(b) [should] be excluded from the taxable portion of any distribution made by reason of a plan participant's death". (Testimony of Assistant Secretary Chapoton, p. 28).

We strongly endorse the Treasury Department's recommendation with respect to the treatment of distributions on account of death for withholding purposes. We respectfully request also that the Committee consider taking some further steps in this area. Specifically, we ask that the Committee consider providing an exclusion from withholding for single-sum death benefits in an amount which, in addition to reflecting the $5,000 statutory exclusion, takes into account the tax effects of personal exemptions and the "zero bracket amount" in the case of a married couple where both husband and wife are under age 65 (for a total exclusion of $10,400 currently).

We recognize that the purpose of these provisions of the bills is to improve the collection of tax on pension income that is (inadvertently, in many cases) not always reported. However, the following competing practical and social policy considerations also seem relevant in this particular area.

1. Death benefits of the type provided by the WCT Plan are largely intended to help beneficiaries (usually spouses) cope with the potentially substantial costs of participants' untimely deaths. In such circumstances, the beneficiaries are least likely to be in a position to cope with complex tax election procedures. Thus, the potential for overwithholding—at a time of immediate financial need—may be quite large.

2. The great majority of private plan participants, and particularly the participants in multiemployer plans, tend to have relatively modest incomes. Thus, the potential tax liability relating to the portion of the death benefit that is not excludable is likely to be small. In any case, source reporting of the taxable portion of the death benefit should minimize any revenue which might nevertheless be lost on account of a slightly higher floor.

3. In addition to the above, a slightly higher floor for one-time death benefits would enable many multiemployer plans—where the administrative costs are borne directly by the plan and its participants and beneficiaries—to avoid the potentially substantially costs and burdens of establishing such systems and procedures as may be necessary to comply with any legislation that is adopted with respect to withholding on non-periodic payments. In this regard, since any rules for such payments are likely to be more complicated than the rules for periodic payments, legitimate questions may be raised as to the justification for imposing such administrative requirements on plans that make non-periodic payments on a very limited basis.

For the above reasons, we respectfully request that the Committee consider providing (in any legislation which it may adopt with respect to withholding on Nonperiodic pension payments) that withholding is not to apply where the payment is made on account of a participant's death and the amount of the payment does not exceed the sum of $5,000 and the personal exemptions and zero bracket amount provided by the Code to a married couple when both persons are under age 65 and file a joint return.

We appreciate this opportunity to provide the Committee with some of our views on this very important subject. We would be pleased to provide additional information on the foregoing issues, or to discuss other aspects of these pension withholding proposals with the Committee or its staff.

Respectfully submitted.

LOUIS T. MAZAWEY
CHARLES A. STORKE
Attorneys for Western Conference of Teamsters Pension Trust Fund

○